

# LANESBOROUGH

The logo for Lanesborough REIT features a stylized icon of a classical building with three columns and a pediment, rendered in a dark blue-grey color. To the right of this icon, the word "REIT" is written in a bold, sans-serif font, matching the color of the icon.

2010 ANNUAL REPORT



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## TABLE OF CONTENTS

|                                                                               |     |
|-------------------------------------------------------------------------------|-----|
| Unitholder Returns and Chief Executive Officer's Message                      | 2   |
| Management's Discussion and Analysis                                          | 5   |
| Financial Summary                                                             | 6   |
| Executive Summary                                                             | 7   |
| Continuing Operations and Liquidity                                           | 13  |
| Overview of Operations and Investment Strategy                                | 15  |
| Impact of Income Tax Changes on Net Sale Proceeds                             | 17  |
| Parsons Landing Financing                                                     | 18  |
| International Financial Reporting Standards                                   | 19  |
| Real Estate Portfolio                                                         | 20  |
| Capital Structure                                                             | 22  |
| Analysis of Income/Loss                                                       | 31  |
| Analysis of Cash Flows                                                        | 43  |
| Capital Resources and Liquidity                                               | 47  |
| Related Party Transactions                                                    | 54  |
| Revenue/Income and Other Commitments                                          | 55  |
| Changes in Accounting Policies                                                | 56  |
| Operating Risks and Uncertainties                                             | 62  |
| Critical Accounting Estimates                                                 | 67  |
| Taxation                                                                      | 68  |
| Internal Controls over Financial Reporting                                    | 69  |
| Additional Information                                                        | 69  |
| Approval by Trustees                                                          | 69  |
| Schedule I - Real Estate Portfolio                                            | 70  |
| Schedule II - Summary of DRIP, NCIBs, Unit Option Plan and Deferred Unit Plan | 72  |
| Management's Responsibility for the Financial Statements                      | 74  |
| Auditor's Report                                                              | 75  |
| Financial Statements                                                          | 76  |
| Unitholder Information                                                        | 116 |



**Unitholder Returns**

|                   | Year Ended<br>December 31, 2010<br>(Per unit) | Year Ended<br>December 31, 2009<br>(Per unit) |
|-------------------|-----------------------------------------------|-----------------------------------------------|
| Cash distribution | -                                             | \$0.09                                        |
| Opening price     | \$0.81                                        | \$2.30                                        |
| Closing price     | \$0.44                                        | \$0.81                                        |

Lanesborough Real Estate Investment Trust Units are listed on the Toronto Stock Exchange under the symbol "LRT.UN". The Series G convertible debentures are listed on the Toronto Stock Exchange under the symbol "LRT.DB.G". The 5 year 9% mortgage bonds due December 24, 2015 and the trust unit purchase warrants are listed on the Toronto Stock Exchange under the symbols "LRT.NT.A", "LRT.WT" and "LRT.WT.A", respectively.

*Foreword*

*The operating results and cash flows of LREIT's portfolio of income-producing properties are disclosed under "continuing operations" in the financial statements of LREIT. As of December, 2010, the portfolio of income-producing properties consists of 19 properties, 13 of which are located in Fort McMurray, Alberta.*

*The operating results and cash flows for properties which were sold or classified as "held for sale" are disclosed under "discontinued operations" in the financial statements of LREIT. The results for 2009 for all sold or "held for sale" properties are also restated under "discontinued operations", for comparative purposes.*

**CHIEF EXECUTIVE OFFICER'S MESSAGE***Income/Loss Results*

During 2010, LREIT incurred a loss from continuing operations before taxes of \$20,461,027, compared to a loss from continuing operations before taxes of \$12,967,629 during 2009. The increase in the loss of \$7,493,398 is mainly attributable to a decrease in operating income from the Fort McMurray property portfolio as a result of a decline in rental housing market conditions which occurred following the economic downturn in October 2008. Operating income from the Fort McMurray property portfolio is lower in 2010, compared to 2009, as revenues declined on a gradual basis during 2009, while, in 2010, revenues remained at a comparatively lower level throughout the year.

For discontinued operations, LREIT completed 2010 with income of \$14,182,120, including a gain on the sale of five properties of \$12,673,702. In 2009, LREIT generated income from discontinued operations of \$19,163,506, including a gain on the sale of 13 properties of \$21,063,885. Income from discontinued operations includes income from properties which are classified as "held for sale" at year end as well as income from the properties which were sold during the year under the divestiture program of LREIT.

After accounting for taxes, LREIT completed 2010 with a net loss of \$6,278,907, compared to a net income of \$3,497,073 in 2009.

*Operating Cash Flows*

LREIT completed 2010, with a cash outflow from operating activities of \$4,220,858, representing a decrease of \$7,698,866, compared to 2009. The decrease in cash flow generally corresponds to the decrease in operating income.

After accounting for the cash flow from the "operations" of discontinued properties of \$2,388,031, the net cash outflow from "operations" was \$1,832,827 during 2010, representing a decrease of approximately \$4.4 Million, compared to 2009.

*Financing and Investing Activities*

During 2010, LREIT continued to access funding to compensate for the decrease in operating cash flow and address the other funding commitments of the Trust. Highlights in this regard, include the following:

- Sale of 5 properties under the divestiture program generated net proceeds of \$14,225,160, after deducting mortgage loans payable debt and the cost of purchasing defeasance assets of \$3,338,341
- Prepayment of mortgage loans provided to purchasers on property sales resulted in proceeds of \$10,090,650, net of prepayment discounts; and
- Proceeds from the initial closing of a mortgage bond offering in December, 2010 generated gross proceeds of \$12,637,000. As of December 31, 2010, cash in escrow includes \$8,947,815 of proceeds from the sale of mortgage bonds and warrants on December 23, 2010 held for the repayment of convertible debenture debt.
- Net proceeds of the revolving loan and line of credit generated \$10,310,000 during 2010.

The proceeds related to property sales, mortgage bond and warrant offerings, the revolving loan and line of credit and the collection of mortgage loans receivable enabled LREIT to fund the cash outflow from operations of \$4.2 Million; the repayment of the Series E debenture of \$11.95 Million; monthly repayment of mortgage loans of \$7.8 Million and establish an escrow reserve for the partial repayment of the Series F debenture.

Other funding requirements during 2010 included escrow deposits of approximately \$8.2 Million and expenditures on transaction costs of \$4.2 Million including fees of approximately \$1.2 Million in regard to mortgage loans payable debt which is in breach of covenant requirements.

*Key Financing Issues*

In January 2011, the second closing of the "December 2010" mortgage bond offering was completed, resulting in additional gross proceeds of \$3,363,000. The additional proceeds, combined with cash in escrow of \$8.9 Million and additional advances from the revolving loan, enabled LREIT to retire the Series F convertible debenture debt of approximately \$13.6 Million in March 2011. The repayment of over \$25 Million of convertible debenture debt during a period of approximately 14 months is a noteworthy achievement, considering the negative economic factors which have affected both the revenue base and mortgage loan financing capabilities of LREIT.

The Series G convertible debentures in the approximate amount of \$25.6 Million mature on December 31, 2011. Management projects that LREIT may generate sufficient proceeds from the sale of properties or upward refinancing to repay the debentures in full on the maturity date, however, LREIT also has the option to satisfy its obligation in regard to the repayment of the principal amount of the Series G debentures by issuing trust units.

LREIT is also continuing to address covenant breaches on individual mortgage loans for approximately \$185.9 Million of mortgage debt. The expectation is that all of the covenants breaches will be resolved through forbearance agreements, waivers or modified loan terms. Additional cash deposits may be required for the loans and additional fees may be incurred in regard to the forbearance agreements.



### Outlook

During 2011, LREIT is pursuing a sale of the four seniors housing complexes which are in its portfolio, as well as other properties. The timing of additional property sales will be a key factor in regard to reducing overall debt levels and interest costs and achieving an improvement in operating income and operating cash flow.

Based on the growth in the level of construction activity in the oil sands industry, the Fort McMurray property portfolio is expected to experience improved occupancy levels in 2011 and achieve an increase in rental revenue. LREIT may, however, continue to require other sources of capital to address debt obligations and property improvements. The net cash proceeds from the sale of properties or upward financing are expected to be sufficient to enable LREIT to meet all of its funding requirements through 2011.



ARNI C. THORSTEINSON, CFA  
Chief Executive Officer  
March 28, 2011

## MANAGEMENT'S DISCUSSION AND ANALYSIS

Management's Discussion and Analysis ("MD&A") of Lanesborough Real Estate Investment Trust ("LREIT" or the "Trust") should be read in conjunction with the consolidated financial statements of LREIT for the year ended December 31, 2010 and with reference to the quarterly reports for 2010.

### Forward-Looking Information

Certain statements contained in this MD&A and in certain documents incorporated by reference herein are "forward-looking statements" that reflect the expectations of management regarding the future growth, results of operations, performance, prospects and opportunities of LREIT. Readers are cautioned not to place undue reliance on forward-looking information. All statements other than statements of historical fact contained or incorporated by reference herein are forward-looking statements including, without limitation, statements regarding the timing and amount of distributions (if any) and the future financial position, business strategy, potential acquisitions, plans and objectives of LREIT. Forward-looking statements are often, but not always, identified by the use of words such as "seek", "anticipate", "plan", "continue", "estimate", "expect", "may", "will", "project", "predict", "potential", "targeting", "intend", "could", "might", "should", "believe" and similar expressions. Such forward-looking statements reflect management's current beliefs and are based on information currently available to management. Forward-looking statements involve significant risks and uncertainties. A number of factors could cause actual results to differ materially from the results discussed in forward-looking statements including risks associated with debt financing, availability of cash for distributions, the taxation of trusts, public markets, real property ownership, liquidity, interest and financing risk, credit risk, concentration of portfolio in one market, future property acquisitions, dependence on natural resources industries, reliance on single or anchor tenants, availability of suitable investments, land leases, general uninsured losses, interest rate fluctuations, Unitholder liability, potential conflicts of interest, changes in legislation and investment eligibility, conversion to international financial reporting standards, multi-family residential sector risk, environmental risks, other tax-related risk factors, supply risk, utility and property tax risk, government regulation, nature of Units, dilution, competition, general economic conditions, current economic conditions, relationship with the property manager, reliance on key personnel and additional risks associated with convertible debentures. Although the forward-looking statements contained or incorporated by reference herein are based upon what management believes to be reasonable assumptions, LREIT cannot assure investors that actual results will be consistent with these forward-looking statements.

The forward-looking statements contained herein are expressly qualified in their entirety by this cautionary statement. Forward-looking statements are made as of the date hereof, or such other date specified in such statements, and neither LREIT nor any other person assumes any obligation to update or revise such forward-looking statements to reflect new information, events or circumstances, except as expressly required by applicable securities law.

### Purchase Price Information

All purchase prices set forth herein are disclosed prior to closing costs, other adjustments on closing and GST, where applicable.

### Divestiture Program

During 2010, LREIT sold 5 properties under its divestiture program, while an additional 7 properties are classified as "properties held for sale" as of December 31, 2010. The operating results for the "sold" and "held for sale" properties, as well as the sale results for the "sold" properties are reported separately in the consolidated financial statements under "discontinued operations", in accordance with generally accepted accounting principles (refer to Note 8 to the consolidated financial statements). The carrying value of "properties held for sale", as reported in accordance with generally accepted accounting principles in the consolidated financial statements, differ from the projected sale price of the properties as disclosed in the MD&A. The number of properties actually sold by LREIT may differ from the number of properties which are classified as "held for sale".

LREIT sold 13 properties during 2009.

The operating results for the 19 income-producing properties of LREIT are reflected in the consolidated financial statements under continuing operations. Assets, liabilities, revenues, expenses and cash flows reflected in this MD&A are in regard to continuing operations, unless otherwise indicated.



## FINANCIAL SUMMARY

|                                                                        | December 31               |                      |
|------------------------------------------------------------------------|---------------------------|----------------------|
|                                                                        | 2010                      | 2009                 |
| <b>BALANCE SHEET</b>                                                   |                           |                      |
| Total assets                                                           | \$ 510,655,612            | \$ 537,144,566       |
| Total long-term financial liabilities (1)                              | \$ 399,193,205            | \$ 434,576,262       |
|                                                                        |                           |                      |
|                                                                        | Year Ended<br>December 31 |                      |
|                                                                        | 2010                      | 2009                 |
| <b>DISTRIBUTIONS</b>                                                   |                           |                      |
| Distributions paid in units                                            | \$ 8,814,286              | \$ 19,504,206        |
| Distributions paid in cash                                             | -                         | 1,530,736            |
| Value of trust units issued under DRIP                                 | -                         | 104,343              |
| Distributions paid on LP units                                         | -                         | 33,285               |
|                                                                        | <u>\$ 8,814,286</u>       | <u>\$ 21,172,570</u> |
| Per unit                                                               | \$ 0.49                   | \$ 1.18              |
| <b>KEY FINANCIAL PERFORMANCE INDICATORS (2)</b>                        |                           |                      |
| <b>Operating Results</b>                                               |                           |                      |
| Total revenue                                                          | \$ 32,345,063             | \$ 40,054,671        |
| Net operating income *                                                 | \$ 19,880,816             | \$ 27,327,326        |
| Loss from continuing operations, before future income tax *            | \$ (20,461,027)           | \$ (12,967,629)      |
| Income (loss) and comprehensive loss                                   | \$ (6,278,907)            | \$ 3,497,073         |
| <b>Cash Flows</b>                                                      |                           |                      |
| Cash flow from operating activities, including discontinued operations | \$ (1,832,827)            | \$ 2,601,301         |
| Funds from Operations (FFO) *                                          | \$ (10,123,539)           | \$ (2,424,203)       |
| Adjusted Funds from Operations (AFFO) *                                | \$ (7,999,360)            | \$ 1,899,181         |
| Distributable income (loss) *                                          | \$ (3,995,724)            | \$ 5,028,604         |
| <b>Per Unit</b>                                                        |                           |                      |
| Net operating income *                                                 |                           |                      |
| - basic                                                                | \$ 1.088                  | \$ 1.558             |
| - diluted                                                              | \$ 0.836                  | \$ 1.102             |
| Loss from continuing operations, before future income tax*             |                           |                      |
| - basic                                                                | \$ (1.120)                | \$ (0.739)           |
| - diluted                                                              | \$ (1.120)                | \$ (0.739)           |
| Income (loss) and comprehensive income (loss)                          |                           |                      |
| - basic                                                                | \$ (0.344)                | \$ 0.199             |
| - diluted                                                              | \$ (0.344)                | \$ 0.199             |
| Distributable income (loss) *                                          |                           |                      |
| - basic                                                                | \$ (0.219)                | \$ 0.287             |
| - diluted                                                              | \$ (0.219)                | \$ 0.287             |
| Funds from Operations (FFO) *                                          |                           |                      |
| - basic                                                                | \$ (0.554)                | \$ (0.138)           |
| - diluted                                                              | \$ (0.554)                | \$ (0.138)           |
| Adjusted Funds from Operations (AFFO) *                                |                           |                      |
| - basic                                                                | \$ (0.438)                | \$ 0.108             |
| - diluted                                                              | \$ (0.438)                | \$ 0.108             |

## (1) Long-Term Financial Liabilities

Long-term financial liabilities consist of the total of the mortgage loans payable as well as convertible debentures and mortgage bonds, at face value.



**(2) Non-GAAP Measurements**

Items marked with an asterisk represent measurements which are not calculated or presented in accordance with Canadian generally accepted accounting principles ("GAAP") or which do not have a standardized meaning as prescribed by GAAP. The non-GAAP measurements may not be comparable to the measurements which are provided by other entities and should not be used as an alternative to the measurements which are determined in accordance with GAAP for purposes of assessing the performance of LREIT. LREIT believes, however, that the non-GAAP measurements are useful in supplementing the reader's understanding of the performance of the Trust. Details regarding the calculation of the non-GAAP measurements and a reconciliation to GAAP measurements, where applicable, are provided in the report.

**EXECUTIVE SUMMARY****Core Business and Strategy**

LREIT was established in order to create a portfolio of income-producing real estate investments. The core business activities of LREIT include investment, development, management and divestiture activities which are focused on maximizing the return on the real estate portfolio.

Prior to 2009, the primary business strategy of LREIT was to achieve growth through the acquisition of new properties. As of December 31, 2008, the real estate portfolio of LREIT consisted of 44 properties with an acquisition cost of approximately \$597 Million, including 13 properties located in Fort McMurray, Alberta.

In 2009, the recession and, in particular, the slow down of economic activity in Fort McMurray resulted in a significant reduction in the operating income and operating cash flows of LREIT. Recessionary influences, combined with the reduced operating cash flows, also negatively impacted the overall financing capabilities of LREIT. In response, LREIT initiated a divestiture strategy in 2009 with the objective of generating \$250 Million of gross proceeds from property sales in order to create funds for the pay down of mortgage and convertible debenture debt and to restore working capital.

As of December 31, 2010, 18 properties have been sold under the divestiture program and 7 other properties are classified as "held for sale". The "income-producing" property portfolio is comprised of the remaining 19 properties.

A more detailed description of the operations and business strategy of LREIT is provided in the section of the MD&A titled, "Overview of Operations and Business Strategy".

**Highlights of 2010 and Key Issues/Events \*****1. Operations**

|                           | Year Ended December 31 |         |
|---------------------------|------------------------|---------|
|                           | 2010                   | 2009    |
| <b>Income properties:</b> |                        |         |
| Average vacancy loss      |                        |         |
| Fort McMurray             | 32 %                   | 22 %    |
| Yellowknife               | - %                    | 1 %     |
| Other                     | 8 %                    | 6 %     |
| Total                     | 26 %                   | 19 %    |
| Average rental rate       |                        |         |
| Fort McMurray             | \$2,339                | \$2,842 |
| Yellowknife               | \$1,923                | \$1,865 |
| Other                     | \$855                  | \$839   |
| Total                     | \$2,103                | \$2,461 |

\* A summary of the key financial performance indicators of LREIT is provided in the section of the MD&A which precedes this section entitled "Financial Summary".

## 2. Income (Loss) and Cash Flow

|                                                                          | Year Ended December 31 |                      |                        |
|--------------------------------------------------------------------------|------------------------|----------------------|------------------------|
|                                                                          | 2010                   | 2009                 | Increase<br>(Decrease) |
| <b>Net operating income from continuing operations</b>                   |                        |                      |                        |
| Fort McMurray properties                                                 | \$ 14,740,112          | \$ 22,936,293        | \$ (8,196,181)         |
| Other properties                                                         | 4,414,826              | 4,364,170            | 50,656                 |
| Trust                                                                    | <u>725,878</u>         | <u>26,863</u>        | <u>699,015</u>         |
| Total net operating income                                               | <u>\$ 19,880,816</u>   | <u>\$ 27,327,326</u> | <u>\$ (7,446,510)</u>  |
| <b>Net income (loss)</b>                                                 |                        |                      |                        |
| Income (loss) from continuing operations, before taxes                   | \$ (20,461,027)        | \$ (12,967,629)      | \$ (7,493,398)         |
| Future income tax expense                                                | -                      | (2,698,804)          | 2,698,804              |
| Income from discontinued operations                                      | <u>14,182,120</u>      | <u>19,163,506</u>    | <u>(4,981,386)</u>     |
| Income (loss) and comprehensive income (loss)                            | <u>\$ (6,278,907)</u>  | <u>\$ 3,497,073</u>  | <u>\$ (9,775,980)</u>  |
| <b>Operating cash flow</b>                                               |                        |                      |                        |
| Cash provided by (used in) operating activities in continuing operations | <u>\$ (4,220,858)</u>  | <u>\$ 3,478,008</u>  | <u>\$ (7,698,866)</u>  |

### **Main factors affecting income (loss) and cash flow results**

- the decrease in net operating income is mainly due to a decrease in revenue from the Fort McMurray property portfolio due to an increase in the average vacancy loss and a decrease in the average rental rate.
- the increase in the loss from continuing operations, before taxes, is mainly due to the decrease in operating income.
- the decrease in income from discontinued operations is mainly due to a decrease in the gain from property sales, as LREIT sold five properties in 2010, compared to 13 properties in 2009.
- the decrease in future income tax expense is due to a \$2.7 Million expense recorded in 2009 associated with the write down of 2008 future income tax assets .
- the decrease in cash provided by operating activities in continuing operations generally corresponds to the decrease in net operating income.



### 3. Financing

#### Financing expense

|                         | Year Ended December 31 |                      |                        |
|-------------------------|------------------------|----------------------|------------------------|
|                         | 2010                   | 2009                 | Increase<br>(Decrease) |
| Total financing expense | <u>\$ 28,793,113</u>   | <u>\$ 29,068,439</u> | <u>\$ (275,326)</u>    |

#### Key Variables

|                                                                                   | December 31  |              |
|-----------------------------------------------------------------------------------|--------------|--------------|
|                                                                                   | 2010         | 2009         |
| Weighted average interest rate of mortgage loans payable debt - Income Properties |              |              |
| Continuing operations                                                             | <u>6.0 %</u> | <u>5.9 %</u> |
| Discontinued operations                                                           | <u>7.1 %</u> | <u>6.6 %</u> |
| Combined operations                                                               | <u>6.3 %</u> | <u>6.1 %</u> |

#### Main factors affecting financing expense

During the first nine months of 2010, the quarterly decrease in net operating income compared to the first nine months of 2009, was either fully or largely offset by a decrease in financing expense. The decrease in financing expense during the first nine months of 2010 was mainly due to a decrease in convertible debenture interest and change in value of interest rate swap arrangements, partially offset by an increase in mortgage loan and mortgage bond interest. As a result of the offsetting impact of financing expense, the net loss from continuing operations before taxes was \$459,090 higher for the nine months ended September 30, 2010, compared to the nine months ended September 30, 2009. During the fourth quarter of 2010, financing expense increased by \$6,399,318 compared to the fourth quarter of 2009 mainly due to the following factors:

- an increase in accretion of \$1,895,913 and an increase in amortization of \$838,423 related to the repayment of the March 2010 mortgage bonds;
- a decrease in the amount of the financing expense reduction related to the change in value of interest rate swap arrangements of \$59,819;
- an increase in amortization charges in regard to mortgage loans payable debt of \$917,283, the majority of which pertains to the amortization of fees which were incurred on the mortgage loans that are in breach of the net operating income achievement and debt service coverage requirements; and
- a \$2.4 Million increase in interest expense as a result of the interest forgiveness for Parsons Landing recovered in the fourth quarter of 2009.

After considering the increase in financing expense in the fourth quarter, the net loss from continuing operations increased by \$7,034,301 during the fourth quarter of 2010, compared to the fourth quarter of 2009. Overall, the net loss from continuing operations, before taxes, increased by \$7,493,398 during 2010, compared to 2009.

### ***Key Financing Issues***

#### ***Parsons Landing***

Although LREIT acquired possession of Parsons Landing on September 1, 2008, the purchase agreement provided for a portion of the purchase price to be paid by February 28, 2009. As LREIT has experienced delays in completing financing, the vendor has agreed to multiple extensions of the payment deadline, subject to certain conditions, including the remittance of monthly interest payments of \$300,000 and a lump-sum principal payment of \$500,000. In October 2010, the payment deadline was extended to June 30, 2011. On closing, the vendor has also agreed to forgive accrued interest in excess of the \$300,000 monthly payments for the period from January 1, 2010 to June 30, 2011. The financial statements for 2010 reflect the forgiveness of excess interest for the entire year in the amount of \$6,910,317.

The vendor has also extended its agreement to provide second mortgage loan financing of \$12 Million provided that LREIT obtains a commitment by April 30, 2011, for sufficient mortgage loan funding to complete the purchase of the property.

More specific details regarding the acquisition of Parsons Landing are provided in the following sections of the MD&A.

#### ***Debt Covenants***

As of December 31, 2010, thirteen properties have mortgage loans which are in breach of the net operating income achievement and debt service coverage requirements and covenant restricting secondary financing (the "covenant breaches") including two "held for sale" properties in Moose Jaw and Winnipeg, and eleven of the income-producing properties in Fort McMurray. In total, the mortgage loans payable debt with covenant breaches for the eleven properties in Fort McMurray amounts to \$160,844,986, representing 62% of the mortgage loans payable debt for continuing operations and 70% of the mortgage loans payable debt for the Fort McMurray property portfolio.

Management believes the default for all of the mortgage loans with covenant breaches will be waived or satisfactorily resolved through forbearance agreements or modified loan terms, although additional cash deposits may be required as security for the mortgages and additional fees may be incurred.

#### ***Convertible Debentures***

As of December 31, 2010, the debt of LREIT included two series of convertible debenture debt, with maturity dates in 2011. As of December 31, 2010, the total face value of the convertible debenture debt was \$39,196,000, comprised of \$13,601,000 of Series F convertible debentures with a maturity date of March 11, 2011 and \$25,595,000 of Series G convertible debentures with a maturity date of December 31, 2011.

The Series F convertible debentures were repaid in full in March 2011.

Management believes that LREIT will generate sufficient proceeds from the sale of properties or upward refinancing to repay the Series G debentures in December 2011. LREIT also has the option to satisfy its obligation in regard to the Series G debentures by issuing trust units to the debenture holders.



#### 4. Liquidity

|                           | December 31     |              |
|---------------------------|-----------------|--------------|
|                           | 2010            | 2009         |
| Unrestricted cash         | \$ 1,697,498    | \$ 4,287,864 |
| Restricted cash           | \$ 20,343,338   | \$ 5,028,520 |
| Working capital (deficit) | \$ (12,693,162) | \$ 1,432,545 |

#### **Key events affecting liquidity in 2010**

- **Property sales:** During 2010, LREIT generated net proceeds of \$17,563,501 from the sale of five properties, after accounting for expenses, the repayment of mortgage loans payable debt and the provision of \$3.8 Million in second mortgage loans to purchasers. In conjunction with one of the sales it was necessary for LREIT to acquire defeasance assets at a cost of \$3,338,341.
- **Mortgage bond and warrant offerings:** During 2010, LREIT generated gross proceeds of \$19,417,000 from two public offerings of 9% mortgage bonds and warrants, comprised of \$6,780,000 from a public offering in March 2010 and \$12,637,000 from the initial closing of a public offering in December 2010. The mortgage bonds of \$6,780,000 from the March 2010 offering were fully repaid at year end. As of December 31, 2010, proceeds from the initial closing of the December 2010 mortgage bond and warrant offering in the amount of \$8,947,815 were placed in escrow for the purpose of partially funding the repayment of the Series F debentures due March 11, 2011.
- **Collection of mortgage loans receivable:** During 2010, proceeds from the collection of mortgage loans receivable amounted to \$10,090,650, net of prepayment discounts of \$250,000.
- **Repayment of convertible debenture debt:** In February 2010, the 8% Series E convertible debenture debt of \$11.95 Million was fully retired.
- **Mortgage loan financing:** During 2010, the following mortgage loan financing transactions were completed:
  - On July 28, 2010, \$2.1 Million in net proceeds were obtained from the upward refinancing of first mortgage debt.
  - In July 2010, \$4,500,000 of second mortgage loan financing was retired.
  - In October 2010, the interim financing in discontinued operations of \$11.9 Million was paid down by \$400,000 and the remaining debt of \$11.5 Million was replaced by a 12.5% interim second mortgage loan of \$11.5 Million.
  - In November 2010, second mortgage loan financing of \$4 Million was registered against "held for sale" properties. The proceeds were used to retire \$4 Million of mortgage debt in continuing operations.
- **Reserves required by mortgage lenders:** During 2010, LREIT provided cash deposits of \$8,211,686 to increase reserves required by mortgage loan agreements, of which \$7,926,000 pertained to mortgage loans with covenant breaches.
- **Transaction costs:** During 2010, expenditures on transaction costs associated with mortgage loan financing and mortgage bond and warrant offerings, amounted to \$4,200,186 including \$1,200,000 of fees associated with the mortgage loans with covenant breaches.
- **Bank line of credit and revolving loan commitment:** During 2010, net withdrawals on the bank line of credit and revolving loan commitment amounted to \$2,960,000 and \$7,350,000, respectively, or \$10,310,000 in total.

### Summary

During 2010, the net cash inflows from property sales, mortgage bond and warrant financing, net proceeds from the revolving loan and line of credit and the collection of mortgage loans receivable were sufficient to fund operating losses, the repayment of the Series E debentures, monthly repayment of approximately \$7.8 Million of mortgage loans payable debt and establish an escrow reserve for the partial repayment of the Series F debentures due March 11, 2011.

As a result of the additional cash reserves which were required for the mortgage loans with covenant breaches, as well as the associated fees, LREIT required additional funding from the line of credit and revolving loan commitment of \$10,310,000 during 2010.

### 5. Divestiture Program

|                      | Properties Sold |               |               |
|----------------------|-----------------|---------------|---------------|
|                      | 2010            | 2009          | Total         |
| Number of properties | 5               | 13            | 18            |
| Gross proceeds       | \$ 40,835,000   | \$ 90,392,000 | \$131,227,000 |
| Net proceeds         | \$ 17,563,501   | \$ 29,631,650 | \$ 47,195,151 |

Net proceeds are calculated after deducting vendor "take-back" financing of \$7,050,000 for properties sold in 2009 and \$3,790,650 for properties sold in 2010. Vendor take-back financing is recorded as mortgage loans receivable and of the \$10,840,650 in vendor take-back financing/mortgage loans receivable provided to purchasers, \$10,090,650 has been received after providing discounts of \$250,000. In summary, \$57,285,801 has been received as a result of the divestiture program.

### Risks and Uncertainties

The key risks and uncertainties affecting the current operations of LREIT include the following:

- the net losses sustained by LREIT in 2009 and 2010;
- the breach of the net operating income achievement and debt service coverage requirements on seven mortgage loans (relating to twelve properties) encompassing \$165.8 Million of mortgage loans payable debt;
- the working capital deficiency of the Trust; and
- the impact of the continuation of high vacancy rates and reduced rental rates in Fort McMurray on the ability of the Trust to renew mortgage loan financing.
- the significant concentration of properties in Fort McMurray and the uncertainty regarding the timing of the economic upturn in Fort McMurray;
- successful completion of the divestiture program;
- ability of the Trust to obtain mortgage financing for Parsons Landing and complete the acquisition of the property; and
- the potential breach of covenant requirements for other mortgage loans.

As a result of the steps which have been taken to address the risk factors, and after considering events which have occurred during 2010 and into 2011, including the repayment of the Series E debentures in February 2010; the repayment of the Series F debentures on March 11, 2011; the completion of two public offerings of secured mortgage bonds and warrants; the renewal or refinancing of mortgage loans and/or positive ongoing discussions with lenders for mortgages which have matured to the date of this report; and the completion of 18 property sales in 2009 and 2010, management believes that LREIT has the financial capacity to continue operations in 2011.

The financial capacity of LREIT to continue operations in 2011 is contingent upon improving cash flows from operations and, in particular, the operating cash flow from the Fort McMurray portfolio; the completion of property sales as planned, the completion of upward refinancing and the continued ability of the Trust to renew or refinance debt at maturity. In the event that the net proceeds from property sales or upward refinancing are less than anticipated, LREIT may not have the ability to fund all of its debt obligations, including regular monthly payments of mortgage loan principal.

A more detailed description of key risks is provided in the "Risks and Uncertainties" section of this report and certain additional risks are described in the Annual Information Form.

## CONTINUING OPERATIONS AND LIQUIDITY

The financial statements have been prepared using the going concern assumption.

The "going concern" basis of accounting is appropriate due to management's expectation of maintaining adequate liquidity, renewing maturing mortgage debt, meeting all interest payment obligations, obtaining forbearance letters, waivers or modified loan terms from lenders, completing upward financing, completing property divestitures and reducing high interest debt and generating additional capital through the completion of property divestitures.

The main variables affecting the liquidity of LREIT for 2011 are:

- *Year End Working Capital Deficiency*

As at December 31, 2010, LREIT has a working capital deficiency of approximately \$12.7 Million, excluding the amount payable on Parsons Landing. The working capital deficiency consists primarily of the amount withdrawn on the revolving loan commitment of \$7.35 Million and accounts payable and accrued liabilities of approximately \$7.3 Million. The maturity date of the revolving loan commitment is June 30, 2011. The accounts payable and accrued liabilities are not overdue and have fixed payment dates in 2011.

- *Funding of Operations and Ongoing Commitments*

During 2010, the cash outflow from operating activities, including the "operations" of discontinued properties was approximately \$1.8 Million. After funding regular payments of mortgage loan principal and property improvements in continuing and discontinued operations, the cash outflow was approximately \$11 Million in 2010. In 2011, the outflow from operations, regular payments of mortgage loan principal and property improvements are expected to be affected by improvements in operating income in 2011, particularly in Fort McMurray based on the expectation that rising oil prices will result in increased activity in the oil sands industry which, in turn, will lead to population growth and an increase in occupancy levels and rental rates for the Fort McMurray properties. As a result, it is anticipated that the total cash outflow will be reduced but not eliminated. The rate and extent of increased demand for rental accommodation is subject to uncertainty. In the event that the increased improvement in operating income is not achieved, it is anticipated that the projected net proceeds from the sale of properties will be more than sufficient to offset any shortfall.



- *Series G Convertible Debentures*

The series G convertible debentures of LREIT are due on December 31, 2011. The debentures have a face value of \$25,595,000, as at December 31, 2010.

The liquidity requirements of LREIT for 2011 are expected to be addressed based on the completion of the following events:

- *Upward Financing*

Management anticipates that it generate net proceeds of approximately \$7 Million from the upward financing of the one or more of the properties which are designated for sale. The financing will be repaid or assumed on the sale of the property or properties.

- *Property Sales*

Management is projecting net proceeds of approximately \$56 Million from the sale of seven properties during 2011, comprised of approximately \$14.7 Million from five properties, \$15.2 Million from one senior housing property and \$26.1 Million from one commercial/residential property. The ability of LREIT to complete the property sales in 2011 is subject to uncertainty. As the date of this report, one of the properties is under a conditional sale contract.

The proceeds from the sale of properties are expected to be sufficient to enable LREIT to meet all of its cash funding requirements through 2011.

During 2009 and 2010, LREIT generated net sale proceeds of approximately \$29.6 Million from the sale of thirteen properties and \$17.6 Million from the sale of five properties, respectively. Management is pursuing the sale of the seven properties in 2011 and believes that the actual sale results for 2009 and 2010 are a good indicator of the ability of LREIT to successfully complete additional property sales in 2011.

- *Revolving Loan Commitment*

It is anticipated that the maturity date of the revolving loan commitment could be extended, as required, as the loan commitment is from 2668921 Manitoba Ltd., the parent company of Shelter Canadian. The extension of the loan would be subject to all necessary regulatory and/or unitowners approvals.

- *Series G Convertible Debentures*

LREIT has the option at the maturity date of the debenture to retire the debentures, in whole or in part, by issuing units.

Other main factors which could impact liquidity of LREIT or affect property operations are:

- *Mortgage Loans in Breach of Covenant Requirements*

As of December 31, 2010, there are 13 properties in the LREIT portfolio that have mortgage loan debt which is in breach of NOI achievement and debt service coverage requirements or restrictions on secondary financing, including eleven properties in Fort McMurray. The willingness of the mortgage lenders to continue to defer direct action against the indebted properties to recover the amount owing under the mortgage loans is subject to uncertainty. The inability of LREIT to maintain its mortgage loan financing for the indebted properties would have adverse consequences on operations.

To date, the breach of covenants have been addressed through forbearance agreements and the provision of additional cash deposits or guarantees and management believes the lenders will continue to address the covenant breaches in a similar manner.

Management of LREIT does not anticipate any lenders of mortgage loans where it is in breach of covenant requirements to demand repayment of such mortgage loans, provided that LREIT continues to be current with its scheduled payments of principal and interest. Management of LREIT expects LREIT to remain current with its scheduled payments of principal and interest. There can be no assurance, however, that lenders will not require mortgage loan repayments.

- *Maturing Debt*

Management of LREIT expects to renew or refinance all mortgage loans which come due during the remainder of 2010 and 2011 with the possible exception of mortgage loans which are in breach of debt service coverage requirements.

- *Completion of the acquisition of Parsons Landing*

Management of LREIT expects that mortgage financing will be obtained and the acquisition of Parsons Landing will be completed.

In summary, management believes that the going concern assumption is appropriate and that LREIT will have sufficient liquidity to address its operating and debt obligations

## OVERVIEW OF OPERATIONS AND INVESTMENT STRATEGY

### General

LREIT is an unincorporated closed-end real estate trust which was established on April 23, 2002, under the laws of the Province of Manitoba. LREIT became a publicly traded entity on August 30, 2002. The trust units of LREIT are listed on the Toronto Stock Exchange under the symbol "LRT.UN" and the Series G convertible debentures are listed on the Toronto Stock Exchange under the symbol "LRT.DB.G". The mortgage bonds and the trust unit purchase warrants are listed on the Toronto Stock Exchange under the symbol "LRT.NT.A", "LRT.WT" and "LRT.WT.A", respectively.

The primary investment objectives of LREIT are to maximize unit values and provide stable cash distributions to the Unitholders by creating a large diversified portfolio of quality real estate investments through the ongoing investment, development, management and divestiture activities of multi-unit residential properties.

The investment policies and operations of LREIT are subject to the overall control and direction of the Trustees, pursuant to the terms of the Declaration of Trust. Shelter Canadian Properties Limited ("Shelter Canadian") provides asset management services to LREIT, pursuant to the terms of a Services Agreement. Shelter Canadian is also responsible for the property management function for the income properties of LREIT, pursuant to the terms of a Property Management Agreement.

The core business activities of LREIT includes acquisition, development, financing, management and divestiture activities pertaining to real estate properties in Canada. As of December 31, 2010, the real estate portfolio of LREIT consists of 18 multi-family residential properties and one commercial property (the "income properties"), as well as seven properties which are classified as "held for sale". Rental revenue from the leasing of the income properties is the primary source of revenue for LREIT.

### **Investment in Properties**

Prior to 2009, the primary investment strategy of LREIT was to expand its income base by acquiring income-producing properties. In 2006 and 2007, LREIT focused its investment activities on the acquisition and development of new residential rental properties in Fort McMurray, Alberta due to the high level of economic growth and the favourable rate of return which was being generated by real estate investments in Fort McMurray prior to the economic downturn which began in 2008.

The new income-producing properties which were acquired or developed by LREIT in Fort McMurray during 2007 and 2008 were primarily responsible for the significant growth in operating income and operating cash flow that was achieved by LREIT in 2008. Subsequent to 2008, the decline in rental housing conditions in Fort McMurray has resulted in a reduction in the profitability of the Fort McMurray property portfolio and a decrease in the overall investment returns of the Trust.

The financial statements of LREIT provide segmented results for the income properties, with "Fort McMurray", "Yellowknife" and "Other" representing the segments. Operating results pertaining to general Trust operations are disclosed separately in the segmented financial information.

### **Operations**

LREIT seeks to maximize the operating income of its property portfolio through the implementation of financial management practices, operating procedures, responsive management services and proactive leasing strategies. LREIT also completes capital improvements and upgrades to its properties on an ongoing basis and undertakes major renovation programs or expansion projects at selected properties, as deemed appropriate.

### **Financing**

The purchase price of new property acquisitions is typically funded from the proceeds of mortgage loans with the remaining balance, or the equity component, funded from other investment capital. The investment capital of LREIT has been primarily raised through the completion of trust unit, or convertible debentures. LREIT also utilizes second mortgage loans, bridge financing and, the upward refinancing of mortgage loans payable debt as a source of investment capital, as well as a bank line of credit and revolving loan commitment from 2668921 Manitoba Ltd., the parent company of Shelter Canadian.

Pursuant to the terms of the Declaration of Trust, the total mortgage loans payable indebtedness of LREIT shall not exceed 75% of the appraised value of LREIT's total property portfolio. As of December 31, 2010, the total mortgage loans payable indebtedness of LREIT was less than 75% of the appraised value of LREIT's total property portfolio.

The ratio of net operating income to mortgage loans payable debt service costs is one of the measures utilized to assess the overall financial position of the Trust. During 2010, the mortgage loans payable debt service coverage ratio for continuing properties was 1.01, compared to 1.08 for the year ended December 31, 2009.



## **Divestiture Program**

LREIT is pursuing a divestiture program targeting the sale of assets, with estimated proceeds in excess of \$250 Million. The objective of the divestiture program is to reduce total debt, including convertible debenture debt and higher cost mortgage loan financing and to restore working capital.

During 2009, LREIT sold 13 properties at a combined gross selling price of \$90.4 Million. The total net proceeds from sale were approximately \$29.6 Million, after accounting for expenses, the repayment or assumption of debt and the provision of take-back financing to some purchasers. The net proceeds permitted the repayment of \$17.1 Million of interim financing in discontinued operations.

During 2010, LREIT sold five additional properties at a combined gross selling price of \$40.4 Million, with two sales occurring during the first quarter of the year, two sales occurring during the third quarter of the year and one sale occurring in the fourth quarter of the year. The total net proceeds from sale were approximately \$17.6 Million, after accounting for expenses, the repayment, assumption of mortgage loans payable debt and the provision of take-back financing to a purchaser. The net proceeds from the first half property sales were used to fund reserves required by mortgage lenders for mortgage loans with covenant breaches and to reduce outstanding advances on the revolving loan and line of credit. The proceeds from the third quarter sales were used to purchase defeasance assets and retire interim mortgage loans payable debt in discontinued operations. The net cash proceeds from the fourth quarter sale were used to reduce the principal balance of mortgage bonds which were issued by LREIT in March 2010.

The December 31, 2010 financial statements classify seven properties as held for sale. The estimated gross sale price and estimate net cash proceeds are \$141.0 Million and \$56.0 Million, respectively. The estimated net cash proceeds are calculated after deducting capital gains tax on the sale. Please refer to Impact on Income Tax Changes on Net Sale Proceeds later in the report.

The sale of these properties, together with the previously sold properties, would create total gross sale proceeds in excess of the \$250 Million proceeds target established for the divestiture program.

## **Distributions**

In March 2009, after paying a distribution of \$0.04667 per unit for January 2009 and February 2009, LREIT implemented a change in its distribution policy from monthly distributions to quarterly distributions. Under the revised distribution policy, the Trust planned to pay quarterly distributions of \$0.06 per unit commencing in the second quarter of 2009. Due to the continued weakness of rental market conditions in Fort McMurray, LREIT did not proceed with the planned distribution for the second quarter of 2009 and, since then, cash distributions have been suspended.

As a result of the extent of property sales, LREIT incurred significant taxable capital gains in 2009 and 2010, which resulted in a corresponding increase in taxable income, before deducting rental loss and distributions. In accordance with the requirements of the Declaration of Trust, LREIT paid "special" distributions in the form of additional units equal to the amount of the realized capital gains on December 31, 2009 and December 31, 2010. The distributions were paid in order to reduce the estimated taxable income of LREIT to nil. The distributions were followed by an immediate consolidation of units, resulting in Unitholders holding the same number of units after the distributions as were held prior to the distributions.

## **IMPACT OF INCOME TAX CHANGES ON NET SALE PROCEEDS**

As previously disclosed in this report, LREIT incurred significant taxable capital gains on property sales in 2009 and 2010, which resulted in a corresponding increase in taxable income. The taxable income was reduced to nil by declaring a "special" distribution, payable in the form of units. From the perspective of the Unitholders, the special distribution represented a taxable capital gain.

Effective January 1, 2011, in accordance with the federal income taxation policy for SIFT's ("specified investment flow-through" trusts), the distributions of LREIT will generally no longer be deductible for purposes of determining the taxable income of LREIT, with certain exceptions\* . As a result, the income tax liability on capital gains from property sales will be payable by LREIT in 2011.

The income tax liability associated with a capital gain will serve to reduce the net proceeds from a property sale to the extent that the property sale results in a capital gain. The estimated net proceeds from the sale of the seven properties which are classified as held for sale as at December 31, 2011 is \$56.0 Million, after deducting the estimated taxes payable on capital gains of \$3.7 Million.

As a result of the direct payment of the tax liability on capital gains, it is anticipated that it will not be necessary for LREIT to declare a special distribution in 2011.

In the event that the four seniors housing complexes of LREIT are sold, LREIT will meet the prescribed conditions necessary to become a "Qualifying REIT". As a "Qualifying REIT", LREIT would once again be in a position to reduce taxable income arising from capital gains through the payment of distributions. The designation as a "Qualifying REIT" would occur in the year following the year in which the sale of all of the seniors housing complexes occurs.

\* A complete explanation of the impact of SIFT rules on the income tax position of the Trust, is included in the MD&A under the title "Taxation".

## PARSONS LANDING FINANCING

Parsons Landing is an apartment property in the Timberlea area of Fort McMurray, Alberta, consisting of a four-storey apartment building, with a total of 160 suites. LREIT acquired possession of Phase I on May 14, 2008 and possession of Phase II effective September 1, 2008.

The purchase price of Parsons Landing was \$63.2 Million, including GST, of which \$15 Million was paid as of December 31, 2008. The purchase agreement for Parsons Landing allowed for the remaining balance of \$48.2 Million to be paid by February 28, 2009. The intent of LREIT was to fund the balance owing with new mortgage loan financing.

As the new mortgage loan financing arrangements were delayed, the vendor agreed to extend the deadline for payment of the balance owing until May 29, 2009, with several subsequent extensions, with the most recent closing date set at June 30, 2011. Each payment extension date has also encompassed an extension of the date for LREIT to obtain a commitment for the mortgage loan financing for the property and a condition that LREIT submit payments of \$300,000 per month on account of interest. A principal payment of \$500,000 occurred on May 12, 2009.

Subject to LREIT remitting an additional payment of \$5 Million prior to closing, the vendor has agreed to provide a second mortgage loan on closing, to a maximum of \$12 Million, for a term of 15 months, at an interest rate of 8% per annum for the first eight months, 12% for the next four months and 24% thereafter. The Vendor has also agreed to provide a credit of \$1,440,000 for furniture purchased by LREIT, on closing. The current agreement to extend the payment deadline date to June 30, 2011 is conditional upon LREIT obtaining a commitment, by April 30, 2011, for sufficient mortgage loan funding to complete the purchase of the property. After providing for \$12 Million of second mortgage loan financing, a minimum payment of \$5 Million to the vendor and a \$1.44 Million furniture credit, LREIT will require approximately \$29.3 Million of funding to complete the purchase of the property.

Although accrued interest on the balance owing amounted to \$9,918,409 during 2009, all interest in excess of the \$300,000 monthly interest payments for the period from March 1, 2009 to December 31, 2009 was forgiven by the vendor. In total, \$5,841,638 of interest was forgiven during 2009, resulting in interest charges on the balance owing being reduced to \$4,076,771.

Subject to the attainment of the required mortgage funding commitment by April 30, 2011, the vendor has agreed to forgive interest in excess of the \$300,000 monthly interest payment for the period from January 1, 2010 to June 30, 2011, on closing. Accrued interest on the balance owing for the period from January 1, 2010 to June 30, 2011 amounts to \$15,722,287 of which \$10,510,317 pertains to 2010. Management estimates that the entire amount of the interest in excess of the \$300,000 monthly interest payments will be forgiven and, as such, the financial statements for the year ended December 31, 2010 reflect the forgiveness of interest in the amount of \$6,910,317.

As of December 31, 2010, the amount payable in regard to the acquisition of Parsons Landing, including GST and excluding accrued interest, is \$47.7 Million.

In addition, LREIT has the right to surrender possession of Parsons Landing, along with the furniture, to the Vendor for the amount of \$1.

## INTERNATIONAL FINANCIAL REPORTING STANDARDS ("IFRS")

LREIT will be adopting International Financial Reporting Standards effective for the 2011 fiscal year. In the quarterly financial statements for 2011, comparative financial information for 2010 will be restated to reflect the retrospective application of IFRS. The retrospective application of IFRS will encompass the restatement of the balance sheet of LREIT, as at January 1, 2010.

The main change in accounting policy that will occur as a result of the adoption of IFRS will be that all of the rental properties of LREIT, with the exception of the four seniors housing complexes, will be considered to be investment properties and will be disclosed in the financial statements using the fair value method of presentation. The restatement of the balance sheet of LREIT as at January 1, 2010, to reflect the retrospective application of IFRS, will encompass the disclosure of investment properties at fair value as at January 1, 2010.

There are differences between IFRS and GAAP in regard to the recognition and measurement of revenues and expenses. The main differences are as follows:

### *Comparative results for 2010*

- amortization expense on rental properties will be eliminated.
- the gain on sale of properties will be eliminated for 2010 as a result of the restatement of the carrying value of the sold properties at fair value as at January 1, 2010.
- the elimination of the gain on sale of properties for 2010 of approximately \$12.7 Million and the elimination of amortization charges on rental properties during 2010 of approximately \$8.7 Million, represents a decrease in income of approximately \$4 Million.
- notwithstanding that the review of the impact of the adoption of IFRS on the financial results of LREIT has not been fully completed, and although there will be other less significant adjustments to income as a result of the adoption of IFRS, the \$4 Million decrease in income provides a general indicator of the impact that the adoption of IFRS will have on the 2010 results, when the 2010 results are restated in 2011 for comparative purposes.



*2011 and subsequent years*

- amortization expense on rental properties will not be charged.
- the gain on the sale of properties will be less than it would otherwise have been under GAAP, as a result of the restatement of the carrying value of investment properties at fair value.
- gains or losses arising from a change in the fair value of investment properties will be recognized in income.
- excluding gains on the sale of properties and gains or losses in the fair value of investment properties, the elimination of amortization charges on rental properties during 2011 will cause income to be higher than it would otherwise have been under GAAP. As noted above, amortization charges on rental properties amounted to approximately \$8.7 Million during 2010.

A complete explanation of the change in accounting policies related to the adoption of IFRS, including an explanation of the financial statement impact of specific accounting policies, is included in the MD&A under the title "Changes in Accounting Policies".

**REAL ESTATE PORTFOLIO****Portfolio Summary - December 31, 2010**

As of December 31, 2010, the property portfolio of LREIT consists of 26 properties, comprised of 19 income-producing properties, and seven properties which are classified as "held for sale". (The seven "held for sale" properties are disclosed under "Assets held for sale" on the balance sheet of the Trust.) The entire property portfolio, including "held for sale" properties, has a total purchase price of approximately \$495.4 Million and encompasses 2,622 suites and 139,243 square feet of leasable area.

As of December 31, 2009, the property portfolio consisted of 31 properties, comprised of 21 income-producing properties and 10 "held for sale" properties. During 2010, five properties were sold, including two income-producing properties that were reclassified as "held for sale" during the year.

A list of all of the properties in the LREIT investment portfolio is provided in Schedule I of this report.

**Composition of Income-Producing Property Portfolio**

The 19 properties which are classified as income-producing properties in continuing operations consist of 13 multi-family residential properties in Fort McMurray, Alberta, two multi-family properties in Yellowknife, Northwest Territories, three multi-family properties located in Thompson, Manitoba, Edson, Alberta and Peace River, Alberta and a commercial property located in Burlington, Ontario.

After considering reclassifications, the income-producing property portfolio consisted of the same 19 properties during 2009 and 2010.

**Properties Sold During 2010**

LREIT sold five properties during 2010, at a combined gross selling price of \$40.4 Million as follows:

- Chancellor Gate, a 48-suite apartment property in Winnipeg, Manitoba was sold, on March 1, 2010.
- McIvor Mall, a 65,283 square foot shopping centre property in Winnipeg, Manitoba was sold on March 1, 2010.
- Woodlily Court, a 102-suite apartment complex in Moose Jaw, Saskatchewan was sold on September 1, 2010.
- Nova Manor, a 32-suite apartment complex in Edmonton, Alberta was sold on September 30, 2010.
- Three Lakes Village, a 50-suite apartment complex in Yellowknife, NWT was sold on November 1, 2010.

After accounting for expenses, the repayment or assumption of mortgage loans payable debt and the provision of "take-back" financing to a purchaser, the sales resulted in net cash proceeds of approximately \$17.6 Million.

### Properties Held for Sale

A property is classified by the Trust as held for sale when the property is available for immediate sale; management has committed to a plan to sell the asset and is actively locating a buyer for the asset at a sales price that is reasonable in relation to current fair value of the asset; and the sale is probable and expected to be completed within a one-year period. As of December 31, 2010, the following seven properties are classified as "held for sale".

| <u>Property</u>                  | <u>Location</u> |
|----------------------------------|-----------------|
| <i>Seniors housing complexes</i> |                 |
| Chateau St. Michael's            | Moose Jaw       |
| Clarington Seniors Residence     | Bowmanville     |
| Elgin Lodge                      | Port Elgin      |
| Riverside Terrace                | Saskatoon       |
| <i>Other properties</i>          |                 |
| Colony Square                    | Winnipeg        |
| 156 / 204 East Lake Blvd.        | Airdrie         |
| Willowdale Gardens               | Brandon         |

Effective January 1, 2011, upon the implementation of International Financial Reporting Standards (IFRS), the "held for sale" portfolio will consist of the four seniors housing complexes. The other three properties will be disclosed under continuing operations.

### Analysis of Operating Results for Properties Held For Sale

The operating results for all properties which were sold during the year, or are being held for sale as of December 31, 2010, are disclosed separately on the Consolidated Statements of Loss and Comprehensive Loss under the line "Income (loss) from discontinued operations".

Accordingly, in this report, the analysis of operating results excludes the revenues and expenses of the properties which were sold or are being held for sale, except where noted.

### Mortgage Loans Receivable

The following schedule reflects the mortgage loan receivable transactions during 2010:

| <u>Mortgage Receivable Due</u> | <u>Balance<br/>December 31,<br/>2009</u> | <u>Vendor Take-<br/>back Mortgage<br/>from 2010<br/>Property Sales</u> | <u>Repayments</u>      | <u>Discounts on<br/>Repayment</u> | <u>Balance<br/>December 31,<br/>2010</u> |
|--------------------------------|------------------------------------------|------------------------------------------------------------------------|------------------------|-----------------------------------|------------------------------------------|
| October 1, 2014                | \$ 500,000                               | \$ -                                                                   | \$ -                   | \$ -                              | \$ 500,000                               |
| June 1, 2011                   | 6,550,000                                | -                                                                      | (6,340,000)            | (210,000)                         | -                                        |
| January 1, 2014                | -                                        | 790,650                                                                | (750,650)              | (40,000)                          | -                                        |
| July 1, 2014                   | -                                        | 3,000,000                                                              | (3,000,000)            | -                                 | -                                        |
|                                | <u>\$ 7,050,000</u>                      | <u>\$ 3,790,650</u>                                                    | <u>\$ (10,090,650)</u> | <u>\$ (250,000)</u>               | <u>\$ 500,000</u>                        |

Mortgage loans receivable arose from vendor take-back financing provided to purchasers in the divestiture program.

## CAPITAL STRUCTURE

### Capital Structure - December 31, 2010

|                                           | December 31, 2010     |               | December 31, 2009     |                |
|-------------------------------------------|-----------------------|---------------|-----------------------|----------------|
|                                           | Amount                | %             | Amount                | %              |
| Mortgage loans payable - principal amount | \$ 259,789,448        | 73.8 %        | \$ 272,574,737        | 74.5 %         |
| Mortgage bonds - face value               | 12,637,000            | 3.6 %         | -                     | -              |
| Convertible debentures - face value       | 39,196,000            | 11.2 %        | 51,362,000            | 14.1 %         |
| Equity                                    | 39,739,235            | 11.3 %        | 41,539,887            | 11.4 %         |
| Total capitalization                      | <u>\$ 351,361,683</u> | <u>99.9 %</u> | <u>\$ 365,476,624</u> | <u>100.0 %</u> |

## Mortgage Loans Payable

### Change in Total Mortgage Loans Payable Debt during 2010

The mortgage loans payable of LREIT are comprised of three components, namely mortgage loans payable for continuing operations, mortgage loans payable for properties "held for sale" and interim mortgage loans payable. The mortgage loans payable for continuing operations are disclosed on the balance sheet of LREIT as "Mortgage Loans Payable". The mortgage loans payable for properties "held for sale" and interim mortgage loans payable are included in "Liabilities of properties held for sale" as disclosed in Note 8 of the financial statements.

In total, the mortgage loans payable, including interim mortgage loans payable, of LREIT was reduced by approximately \$35.9 Million during 2010, of which approximately \$12.7 Million pertains to continuing operations. An analysis of the total debt reduction during 2010 is included in the following chart.

|                                                                        | Year Ended December 31, 2010 |                       |                         |
|------------------------------------------------------------------------|------------------------------|-----------------------|-------------------------|
|                                                                        | Total                        | Continuing Operations | Discontinued Operations |
| Proceeds of mortgage loan financing                                    | \$ 20,500,000                | \$ 5,000,000          | \$ 15,500,000           |
| Repayment of mortgage loans on refinancing                             | (6,936,649)                  | (6,936,649)           | -                       |
| Repayment of interim mortgage loans on refinancing                     | (2,000,000)                  | -                     | (2,000,000)             |
| Net proceeds (repayment)                                               | 11,563,351                   | (1,936,649)           | 13,500,000              |
| Regular repayment of principal on mortgage loans                       | (7,785,434)                  | (6,348,643)           | (1,436,791)             |
| Repayment of interim mortgage loans                                    | (13,872,605)                 | -                     | (13,872,605)            |
| Repayment of mortgage loans from proceeds of mortgage loans receivable | (4,500,000)                  | (4,500,000)           | -                       |
| Mortgage loans retired or assumed by purchasers *                      | (21,259,113)                 | -                     | (21,259,113)            |
| Total debt repaid/eliminated                                           | (35,853,801)                 | (12,785,292)          | (23,068,509)            |
| Transaction cost/market interest rate adjustments **                   | (147,547)                    | 84,412                | (231,959)               |
| Total debt reduction                                                   | (36,001,348)                 | (12,700,880)          | (23,300,468)            |
| Total mortgage and interim loans payable - December 31, 2009           | <u>381,844,877</u>           | <u>271,414,070</u>    | <u>110,430,807</u>      |
| Total mortgage and interim loans payable - December 31, 2010           | <u>\$ 345,843,529</u>        | <u>\$ 258,713,190</u> | <u>\$ 87,130,339</u>    |

\* Mortgage loans retired includes a \$2,818,509 mortgage loan which is classified as a defeased liability as of December 31, 2010.

\*\* Consists of the change in unamortized transaction costs and the change in the difference between contractual and market interest rates on mortgage loans assumed.



As disclosed in the following chart, the total debt reduction in the fourth quarter of 2010 was \$9,932,124 or 27.6% of the total reduction for the entire year. The fourth quarter debt reduction consists of regular repayments of principal of \$2,034,697, the assumption of \$6,995,048 of first mortgage loans payable debt by the purchaser of Three Lakes Village at sale of the property and the repayment of \$4,000,000 of second mortgage loans payable debt in continuing operations and \$9,899,740 of interim loan debt in discontinued operations partially offset by the net proceeds of \$13.5 Million of new interim loan financing.

|                                                               | Three Months Ended December 31, 2010 |                       |                         |
|---------------------------------------------------------------|--------------------------------------|-----------------------|-------------------------|
|                                                               | Total                                | Continuing Operations | Discontinued Operations |
| Proceeds of mortgage loan financing                           | \$ 15,500,000                        | \$ -                  | \$ 15,500,000           |
| Repayment of mortgage loans on refinancing                    | (4,000,000)                          | (4,000,000)           | -                       |
| Repayment of interim mortgage loans on refinancing            | (2,000,000)                          | -                     | (2,000,000)             |
| Net proceeds (repayment)                                      | 9,500,000                            | (4,000,000)           | 13,500,000              |
| Regular repayment of principal on mortgage loans              | (2,034,697)                          | (1,672,453)           | (362,244)               |
| Repayment of interim mortgage loans                           | (9,899,740)                          | -                     | (9,899,740)             |
| Mortgage loans assumed by purchaser                           | (6,995,048)                          | -                     | (6,995,048)             |
| Total debt repaid/eliminated                                  | (9,429,485)                          | (5,672,453)           | (3,757,032)             |
| Transaction cost/market interest rate adjustments             | (502,639)                            | (130,136)             | (372,503)               |
| Total debt reduction                                          | (9,932,124)                          | (5,802,589)           | (4,129,535)             |
| Total mortgage and interim loans payable - September 30, 2010 | 355,775,653                          | 264,515,779           | 91,259,874              |
| Total mortgage and interim loans payable - December 31, 2010  | <u>\$ 345,843,529</u>                | <u>\$ 258,713,190</u> | <u>\$ 87,130,339</u>    |

### Composition of Mortgage Loans Payable Debt - December 31, 2010

#### Continuing Operations

##### Summary of Mortgage Loans Payable - Continuing Operations

| Year of Maturity              | Weighted Average Interest Rate | Amount December 31, 2010 | Percentage of Total |
|-------------------------------|--------------------------------|--------------------------|---------------------|
| Fixed rate                    |                                |                          |                     |
| 2011 <sup>(1)</sup>           | 5.7 %                          | \$ 20,915,883            | 8.1 %               |
| 2012                          | 5.5 %                          | 29,212,843               | 11.2 %              |
| 2013 <sup>(2)</sup>           | 5.8 %                          | 42,340,743               | 16.3 %              |
| 2014                          | 6.3 %                          | 34,877,322               | 13.4 %              |
| 2015                          | 4.8 %                          | 6,789,555                | 2.6 %               |
| 2016                          | 5.2 %                          | 32,019,235               | 12.3 %              |
| 2018 <sup>(2)</sup>           | 5.8 %                          | 21,693,020               | 8.4 %               |
|                               |                                | 187,848,601              | 72.3 %              |
| Demand/variable rate          | 6.7 %                          | 71,940,847               | 27.7 %              |
| Principal amount              |                                | 259,789,448              | 100.0 %             |
| Unamortized transaction costs |                                | (1,076,258)              |                     |
|                               |                                | <u>\$ 258,713,190</u>    |                     |

(1) Mortgage loans payable includes a 7.5% second mortgage loan in the amount of \$500,000 from 2668921 Manitoba Ltd., the parent company of Shelter Canadian, with a due date of January 1, 2011. The maturity date was subsequently extended to June 30, 2011.

(2) Includes swap interest rate mortgages of \$21,693,020 and \$19,545,006, with interest rates fixed at 5.82% and 5.74% respectively by use of interest rate swap arrangements.

**Mortgage Loans Payable Debt Summary \***

|                                                                                                                                                                                | 2010 |      |      |      |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|------|------|------|
|                                                                                                                                                                                | Q 4  | Q 3  | Q 2  | Q 1  |
| Weighted average interest rate                                                                                                                                                 |      |      |      |      |
| Fixed rate mortgage loans                                                                                                                                                      | 5.7% | 5.7% | 5.8% | 5.8% |
| Variable rate mortgage loans                                                                                                                                                   | 6.7% | 6.7% | 6.2% | 5.9% |
| Ratio of mortgage loans payable, compared to:<br>Purchase price of income-producing properties                                                                                 | 81%  | 83%  | 84%  | 85%  |
| Ratio of mortgage loans payable, convertible debenture debt (at<br>face value) and mortgage bonds (at face value) compared to<br>purchase price of income-producing properties | 98%  | 98%  | 99%  | 100% |
|                                                                                                                                                                                | 2009 |      |      |      |
|                                                                                                                                                                                | Q 4  | Q 3  | Q 2  | Q 1  |
| Weighted average interest rate                                                                                                                                                 |      |      |      |      |
| Fixed rate mortgage loans                                                                                                                                                      | 5.8% | 5.9% | 5.9% | 5.9% |
| Floating rate mortgage loans                                                                                                                                                   | 5.9% | 3.7% | 3.7% | 4.0% |
| Ratio of mortgage loans payable, compared to:<br>Purchase price of income-producing properties                                                                                 | 86%  | 84%  | 85%  | 86%  |
| Ratio of mortgage loans payable, convertible debenture debt (at<br>face value) and mortgage bonds (at face value) compared to<br>purchase price of income-producing properties | 102% | 101% | 102% | 102% |

\* Excludes debt and property values for "held for sale" properties and Parsons Landing.

**Discontinued Operations**

As disclosed in the analysis at the beginning of the "mortgage loans payable" section of this report, the mortgage loans payable debt for discontinued operations was reduced by \$23,300,468 during 2010, resulting in a balance of \$87,130,339 as of December 31, 2010.

The total balance of \$87,130,339 is comprised of first and second mortgage loans payable debt with a face value of \$72,125,757, net of unamortized transaction costs of \$12,807 and interim mortgage loans payable debt with a face value of \$15,445,000, net of unamortized transaction costs of \$427,611. The first and second mortgage loans payable debt has a weighted average interest rate of 7.1% as of December 31, 2010.

The interim mortgage loan is comprised of a 12.5% interim second mortgage loan of \$11.5 Million due January 1, 2012 and a 12% interim second mortgage loan of \$3.95 Million due May 1, 2012. The \$11.5 Million loan requires monthly payments of interest only and the \$3.95 Million loan requires monthly payments of principal and interest.

**Debt Maturities****Continuing Operations**

With the exception of two mortgage loans for properties in breach of debt service coverage requirements, all of the mortgage loans for continuing operations which matured to December 31, 2010 were renewed, refinanced or repaid/assumed by purchaser on sale. The two loans consist of the 5.5% first mortgage loan of \$18,424,309 for the Lakewood Townhouses which matured on July 18, 2010 and the 6.5% second mortgage loan of \$17,501,827 for Woodland Park and Nelson Ridge Estates which matured on October 31, 2010. The loans are repayable on demand. A forbearance agreement was obtained from the lender in regard to the covenant breaches for both of the loans with an expiry date of January 31, 2011 and an extension to June 30, 2011 is expected to be provided by the lender.

As of December 31, 2010, the amount of mortgage loan principal which is considered repayable during 2011, as disclosed in the financial statements in accordance with GAAP, includes all mortgage loans which are payable on demand and all mortgage loans with covenant breaches, as well as fixed term mortgages which mature during 2011. An analysis of the total mortgage loan principal which is considered repayable for financial statement reporting purposes, for both continuing and discontinued operations, is provided in the "Capital Resources and Liquidity" section of the MD&A.

The only mortgage loan debt maturing during the first half of 2011, is Norglen Terrace with a \$1,991,574 first mortgage loan which matured January 1, 2011 and is expected to be refinanced with a new five year loan and a \$500,000 second mortgage loan, due June 30, 2011.

For the remainder of 2011, one mortgage loan in the amount of \$54,439,020 will mature October 2011.

#### *Discontinued Operations*

All of the mortgage loans for discontinued operations which matured prior to December 31, 2010 were renewed or replaced.

Two mortgage loans for properties classified as held for sale are being refinanced, as follows:

- Chateau St. Michael's - \$4,976,540, 5.7% became due March 1, 2011 and is expected to be extended for a term of one year.
- Clarington Seniors Residence - \$14,870,000, weighted average interest rate of 7% became due March 27, 2011 and is expected to be renewed for a term of one year.

None of the other mortgage loans for properties classified as held for sale mature during the balance of 2011.

#### **Debt Covenants**

There are 13 income-producing properties in Fort McMurray, 12 of which are encumbered by mortgage loans payable debt. The exception is Parsons Landing which is under contract to purchase.

Of the 12 properties in Fort McMurray which are encumbered by mortgage loans payable debt, 11 of the properties have mortgage loans which are in breach of the net operating income achievement or debt service coverage requirements. The debt for the properties consists of five first mortgage loans and one second mortgage loan, including the two loans which matured in 2010 and are payable on demand, as discussed in the preceding section of this report. The covenant breaches for the 11 Fort McMurray properties were a result of the negative impact of the slow down of development activity in the oil sands industry and the associated decline in rental market conditions in Fort McMurray.

The first mortgage loan for the seniors housing complex in Moose Jaw, Saskatchewan is in breach of the debt service coverage requirement for the years ended December 31, 2009 and December 31, 2010. The first mortgage loan for a mixed residential/commercial property in Winnipeg, Manitoba is in breach of a covenant which restricts second mortgage financing. The Moose Jaw and Winnipeg properties are classified as "held for sale".



The status of the mortgage loans which are in breach of the net operating income achievement, debt service coverage requirements or secondary financing restrictions is provided below.

| <u>Property</u>                      | <u>Covenant Requirement</u> | <u>Type of Mortgage</u> | <u>Mortgage Balance<br/>December 31, 2010</u> | <u>Maturity Date</u> | <u>Status</u> |
|--------------------------------------|-----------------------------|-------------------------|-----------------------------------------------|----------------------|---------------|
| Fort McMurray                        |                             |                         |                                               |                      |               |
| Gannet Place, Lunar Apartments,      |                             |                         |                                               |                      |               |
| Parkland Apartments, Skyview         |                             |                         |                                               |                      |               |
| Apartments, Snowbird Manor, Whimbrel | NOI                         | First                   | \$ 23,386,597                                 | September 1, 2016    | (1)           |
| Terrace                              | achievement                 | First                   | 21,693,020                                    | June 4, 2018         | (1)           |
| Millennium Village                   | (6)                         |                         |                                               |                      |               |
| Lakewood                             |                             |                         |                                               |                      |               |
| Apartments                           | 1.2                         | First                   | 25,400,213                                    | July 17, 2014        | (3)           |
| Townhouses                           | 1.1                         | First                   | 18,424,309                                    | July 18, 2010        | (2)           |
|                                      |                             |                         | <u>88,904,139</u>                             |                      |               |
| Laird's Landing                      | 1.2                         | First                   | 54,439,020                                    | October 1, 2011      | (2)           |
| Woodland Park, Nelson Ridge Estates  | 1.2                         | Second                  | 17,501,827                                    | October 31, 2010     | (2)           |
|                                      |                             |                         | <u>71,940,847</u>                             |                      |               |
| Subtotal                             |                             |                         | <u>160,844,986</u>                            |                      |               |
| Moose Jaw                            |                             |                         |                                               |                      |               |
| Chateau St. Michael's                | 1.3                         | First                   | 4,976,540                                     | March 1, 2011        | (4)           |
| Winnipeg                             |                             |                         |                                               |                      |               |
| Colony Square                        | (7)                         | First                   | 20,064,829                                    | April 1, 2015        | (5)           |
| Subtotal                             |                             |                         | <u>25,041,369</u>                             |                      |               |
|                                      |                             |                         | <u>\$ 165,821,526</u>                         |                      |               |

(1) The lender has been notified of the breach and is being provided with operating information on a monthly basis.

(2) The lender provided a forbearance agreement to January 31, 2011. An extension is anticipated.

(3) The terms of the forbearance are under negotiation.

(4) The lender has been advised of the breach and a waiver has been requested.

(5) The lender has issued a Notice regarding the breach demanding that secondary financing be removed from the title to the property.

(6) The covenant requirement is a 1.15 debt service coverage for all Trust operations.

(7) The lenders has issued a Notice of Default as a result of secondary financing being registered on title to the property.

As disclosed in the preceding table, LREIT is resolving covenant breaches for all of the loans. Management believes that all of the covenant breaches will be satisfactorily resolved through modified loan agreements or extensions of forbearance agreements. During 2010, the total fees related to covenant breaches and forbearance agreements amounted to \$1.2 Million, of which \$692,000 was expensed during 2010 under "financing expense". The remaining amount is included in unamortized transaction costs as of December 31, 2010. The fees associated with the forbearance agreements contributed to proportionately high financing expenses in the fourth quarter of 2010, compared to the first three quarters of the year.

During 2010, LREIT also provided cash deposits of \$7,926,000 on four of the mortgage loans with covenant breaches, including \$1,177,300 that was provided on one of the loans which matured in 2010.

Notwithstanding the fact that the Fort McMurray property portfolio is expected to achieve improved occupancy and income levels in 2011, all of the affected properties may not attain income levels in 2011 which satisfy the existing covenant requirements. LREIT intends to sell the seniors housing complex in Moose Jaw and the mixed residential/commercial building in Winnipeg, Manitoba.

Management anticipates that all lenders of mortgage with covenant breaches will not demand early repayment of such mortgage loans, provided that scheduled payments of principal and interest continue to be made by the due date. There can be no assurance, however, that lenders will not accelerate such mortgage loans.

The covenant breaches have not resulted in an acceleration of the repayment of the mortgage loans. There is no assurance that the lenders will not accelerate payment of the mortgage loans. There are no cross-default covenants with respect to the other mortgage loans of the Trust other than mortgage loans on income properties which secure the mortgage bonds.

### **Weighted Average Interest Rates**

As of December 31, 2010, the weighted average interest rate of the mortgage loans payable debt for continuing operations, discontinued operations and combined operations is 6.0%, 7.1% and 6.3%, respectively.

The weighted average interest rate for mortgage loans payable debt excludes interest on the acquisition amount payable on Parsons Landing.

### **Acquisition Payable**

As previously advised, the amount payable in regard to the acquisition of Parsons Landing is \$45.2 Million, excluding GST. The amount payable was originally due on February 28, 2009. During the period from March 1, 2009 to December 31, 2009, interest charges in excess of \$300,000 per month totaling \$5,841,638 were forgiven by the vendor. Interest charges in excess of \$300,000 per month for the period from January 1, 2010 to June 30, 2011 will be forgiven by the vendor, on closing, provided that LREIT obtains a commitment for sufficient mortgage loan funding by April 30, 2011 to complete the acquisition of the property. Interest charges of \$300,000 per month represent an effective interest rate of 8%.

Interest charges in excess of \$300,000 per month for the period from January 1, 2010 to June 30, 2011 amount to \$10,322,287 of which \$6,910,317 pertains to 2010. Management estimates that the entire amount of the excess interest will be forgiven and, as such, the financial statements for 2010 reflect the forgiveness of interest in the amount of \$6,910,317.

The amount payable on the acquisition of Parsons Landing is included in "Accounts payable and accrued liabilities" on the Consolidated Balance Sheet of LREIT.

### **Revolving Loan Commitment**

In June 2009, LREIT obtained a \$2.7 Million revolving loan commitment from 2668921 Manitoba Ltd. the parent company of Shelter Canadian at an interest rate of 7.5%. In September 2009, the revolving loan commitment was increased to \$5 Million. During 2009, the maximum amount withdrawn on the loan commitment was \$4,905,000. All withdrawals were repaid as of December 31, 2009.

In November 2010, the revolving loan commitment was increased to \$10 Million, the maturity date was extended from December 31, 2010 to June 30, 2011 and the interest rate was increased from 7.5% to 14%. During 2010, the maximum amount withdrawn on the loan commitment was \$7,350,000. As of December 31, 2010, the outstanding balance of the loan commitment is \$7,350,000.

During 2010, the total financing expense associated with the revolving loan commitment was \$189,861, compared to \$93,106 in 2009. The revolving loan is included in "Accounts Payable and accrued liabilities" on the consolidated Balance Sheet of LREIT. Additional information regarding the financing arrangements with 2668921 Manitoba Ltd. are provided in the section of this report titled "Related Party Transactions".

## Mortgage Bonds and Warrants

On December 23, 2010, LREIT completed the initial closing of a public offering (the "December 2010 Bond Offering") of investment units. Pursuant to the initial closing, 12,637 units were sold at a price of \$1,000 per Unit for aggregate gross proceeds of \$12,637,000. Each unit was comprised of one five year 9% mortgage bond in the principal amount of \$1,000 due December 24, 2015 and 1,000 unit purchase warrants. Each warrant entitles the holder thereof to purchase one unit of LREIT at a price of \$0.75 per unit at any time for a period of five years ending December 23, 2015.

In December 2010, approximately \$2.6 Million of the proceeds from the initial closing of the December 2010 Bond Offering were used to repay the remaining principal balance of the 5 year, 9% mortgage bonds due March 10, 2015 which were issued by the Trust in March 2010 (The mortgage bonds due March 10, 2015 were originally issued on March 9, 2010 in the total amount of \$6.78 Million. Approximately \$4.15 Million of the principal amount of such mortgage bonds were repaid in November 2010 from the net proceeds from the sale of Three Lakes Village). The remaining proceeds from the initial closing were held in escrow as of December 31, 2010.

On January 28, 2011, the second closing of the December 2010 Bond Offering occurred, in which an additional 3,363 investment units were sold at \$1,000 per Unit for aggregate gross proceeds of \$3,363,000. The proceeds from the second closing, combined with the mortgage bond funds held in escrow and additional draws on the revolving loan, were used to repay the 7.5% Series F convertible debentures in March 2011.

The mortgage bonds mature on December 24, 2015. Interest is payable semi-annually on May 31 and November 30 in each year, as well as on the maturity date, with the first interest payment occurring on May 31, 2011. Interest is based on the aggregate face value of the mortgage bonds of \$16,000,000. The bonds are secured by second mortgages registered against five income properties.

For financial statement purposes, the initial book value of the warrants and mortgage bonds from the initial closing of the December 2010 Bond Offering was determined to be \$2,190,000 and \$10,447,000, respectively, based on valuation methodology as established under GAAP. The carrying value of the mortgage bonds, as of December 31, 2010, of \$9,317,075 is based on the initial book value, plus accretion and deducting unamortized transaction costs. The value of the warrants is recognized in equity and the value of the mortgage bonds is recognized as a liability of LREIT.

Upon repayment of the March 2010 mortgage bonds, the unrecognized accretion (i.e., the difference between the carrying value of the mortgage bonds and the face value of the bonds) of \$1,895,913, as well as unamortized transaction costs of \$838,423, were fully expensed in the fourth quarter of 2010 under "financing expense". The accretion and amortization charges contributed to a proportionately high level of financing expense in the fourth quarter of 2010, compared to the first three quarters of the year.

The Bond Indenture which governs the mortgage bonds of LREIT provides for the bonds to become payable on demand in the event that the Series G debentures or any of the first mortgages on Beck Court, Nova Court, Norglen Terrace, Highland Tower or Westhaven Manor are in default for more than ten days and the default results in the acceleration of debt payments. The Bond Indenture also stipulates that in the event of a sale of any of the five encumbered properties, the net proceeds of sale will be used to reduce the principal balance of the mortgage bonds.

On March 9, 2010, LREIT completed a public offering (the "March 2010 Bond Offering") of investment units, under which 6,780 investment units were sold at a price of \$1,000 per Unit for aggregate gross proceeds of \$6.78 Million. Each unit was comprised of one five year 9% mortgage bond in the principal amount of \$1,000 due March 10, 2015 and 1,000 unit purchase warrants. Each warrant entitles the holder thereof to purchase one unit of LREIT at a price of \$1.00 per unit at any time for a period of five years expiring March 9, 2015.



As noted above, the mortgage bonds from the March 9, 2010 offering were retired. The warrants may be exercised at any time until the March 9, 2015 expiry date.

## Convertible Debentures

The Declaration of Trust for LREIT does not impose any limitations on the amount of convertible debt which may be issued by the Trust. The following is a summary of the debenture offerings which have been undertaken by LREIT, as of December 31, 2010.

### Summary of Debenture Offerings

| Issue Date/Maturity Date        | Series | Interest Rate | Amount Issued        | Repayments/Unit Conversions/Repurchases |                        | Net Amount Outstanding December 31 2010 |
|---------------------------------|--------|---------------|----------------------|-----------------------------------------|------------------------|-----------------------------------------|
|                                 |        |               |                      | Year Ended December 31 2010             | As of December 31 2009 |                                         |
| Aug. 30/02/Aug. 30/07           | A      | 10.0 %        | \$ 3,000,000         | \$ -                                    | \$ (3,000,000)         | \$ -                                    |
| Aug. 30/02/Aug. 30/05           | B      | 8.0 %         | 1,000,000            | -                                       | (1,000,000)            | -                                       |
| Jan. 30/04/Jan. 30/06           | C      | 8.0 %         | 10,131,000           | -                                       | (10,131,000)           | -                                       |
| Mar. 16/04/Mar. 16/08           | D      | 8.0 %         | 4,000,000            | -                                       | (4,000,000)            | -                                       |
| Feb. 17/05/Feb. 17/10           | E      | 8.0 %         | 12,000,000           | (11,950,000)                            | (50,000)               | -                                       |
| Mar. 10/06/Mar. 11/11           | F      | 7.5 %         | 13,680,000           | (79,000)                                | -                      | 13,601,000                              |
| Dec. 8/06/Dec. 31/11            | G      | 7.5 %         | 25,732,000           | (137,000)                               | -                      | 25,595,000                              |
| Face value                      |        |               | <u>\$ 69,543,000</u> | <u>\$ (12,166,000)</u>                  | <u>\$ (18,181,000)</u> | 39,196,000                              |
| Net accumulated accretion       |        |               |                      |                                         |                        | 8,429,595                               |
| Unamortized transaction costs   |        |               |                      |                                         |                        | <u>(426,282)</u>                        |
| Book value, December 31, 2010   |        |               |                      |                                         |                        | <u>\$ 47,199,313</u>                    |
| <u>Allocation of book value</u> |        |               |                      |                                         |                        |                                         |
| Debt component                  |        |               |                      |                                         |                        | \$ 37,412,928                           |
| Equity component                |        |               |                      |                                         |                        | 10,212,667                              |
| Unamortized transaction costs   |        |               |                      |                                         |                        | <u>(426,282)</u>                        |
|                                 |        |               |                      |                                         |                        | <u>\$ 47,199,313</u>                    |

As disclosed in the preceding chart, the Series E convertible debentures in the amount of \$11,950,000 were paid in full in March 2010. The Series F debentures in the amount of \$13,598,000 were paid in full on March 11, 2011.

The Series G debentures are convertible at the option of the holder, at any time prior to the maturity date or, if applicable, the redemption date, at \$7.00 per unit. The debentures are redeemable by LREIT, in years four and five only, at a price equal to the principal amount plus accrued and unpaid interest, subject to certain conditions.

In accordance with the terms of the Trust indenture for the Series G debentures, the Trust has the option at the maturity of the Series G debentures to retire the debentures, in whole or in part, by issuing units. The number of units issued at redemption is determined by dividing the principal of debentures redeemed by 95% of the current market price of the units.

## Defeasance Assets and Liability

On the closing date of sale of Woodlily Courts on September 1, 2010, an existing 5.65% mortgage loan of \$2,818,509 was not discharged due to the nature of the loan security, and, as a result, the loan was defeased. In this regard, LREIT placed Government of Canada Bonds, Government of Canada Treasury Bills and Canada Mortgage Bonds in escrow to fully secure the loan in replacement of the mortgage security which was discharged. The purchase price of the defeasance assets, including transaction costs, was \$3,338,341. The purchase of the defeasance assets was funded from the net sale proceeds from Woodlily Courts.

The defeased loan is disclosed on the balance sheet of LREIT as a "defeased liability". Bonds held in escrow are disclosed as "defeasance assets".

The defeasance assets and the defeased liability will be measured at amortized cost using the effective interest rate method of calculation until the maturity date of the defeased loan on July 1, 2016. On July 1, 2016, the defeased mortgage will be retired from the proceeds from the realization of the defeasance assets.

Interest on the defeasance assets are included in interest income of the Trust. Interest payments in regard to the defeased loan and amortization of transaction cost are included in financing expense of the Trust.

## Trust Units

### Units Outstanding

|                     |            |
|---------------------|------------|
| Authorized          | unlimited  |
| Issued as of,       |            |
| - December 31, 2009 | 17,893,767 |
| - December 31, 2010 | 17,988,339 |
| - March 28, 2011    | 17,988,339 |

As of December 31, 2010, LREIT had 17,988,339 units outstanding, representing an increase of 94,572 units compared to the number of units outstanding as of December 31, 2009. The 94,572 units which were issued during 2010 originated from the exchange of deferred units for issued units upon the resignation of one of the Trustees in the third quarter of 2010.

A summary of the Distribution Reinvestment Plan (DRIP), the Normal Course Issuer Bids (NCIBs), Unit Option Plan and the Deferred Unit Plan are provided on Schedule II.

## ANALYSIS OF INCOME/LOSS

### Overall Results

#### Analysis of Income (Loss)

|                                                                     | Year Ended December 31 |                     | Increase (Decrease)   |                 |
|---------------------------------------------------------------------|------------------------|---------------------|-----------------------|-----------------|
|                                                                     | 2010                   | 2009                | Amount                | %               |
| Rental revenue                                                      | \$ 31,385,914          | \$ 39,662,949       | \$ (8,277,035)        | (20.9)%         |
| Interest and other income                                           | 959,149                | 391,722             | 567,427               | 144.9 %         |
| Property operating costs                                            | 12,464,247             | 12,727,345          | (263,098)             | (2.1)%          |
| Net operating income (NOI) *                                        | 19,880,816             | 27,327,326          | (7,446,510)           | (27.2)%         |
| Trust expense                                                       | 3,035,583              | 2,760,536           | 275,047               | 10.0 %          |
| Income before financing expense, amortization, and taxes (EBITDA) * | 16,845,233             | 24,566,790          | (7,721,557)           | (31.4)%         |
| Financing expense                                                   | 28,793,113             | 29,068,439          | (275,326)             | (0.9)%          |
| Loss before amortization and taxes *                                | (11,947,880)           | (4,501,649)         | (7,446,231)           | 165.4 %         |
| Amortization                                                        | 8,513,147              | 8,465,980           | 47,167                | 0.6 %           |
| Loss before future income tax *                                     | (20,461,027)           | (12,967,629)        | (7,493,398)           | 57.8 %          |
| Future income tax expense                                           | -                      | 2,698,804           | (2,698,804)           | (100.0)%        |
| Loss from continuing operations                                     | (20,461,027)           | (15,666,433)        | (4,794,594)           | 30.6 %          |
| Income from discontinued operations                                 | 14,182,120             | 19,163,506          | (4,981,386)           | (26.0)%         |
| Income (loss) and comprehensive income (loss)                       | <u>\$ (6,278,907)</u>  | <u>\$ 3,497,073</u> | <u>\$ (9,775,980)</u> | <u>(279.5)%</u> |

\* The analysis of loss for the year represents the re-formatting of balances from the Consolidated Statements of Income in order to provide a summarized analysis of the financial performance of the Trust. All of the lines in the analysis agree to amounts in the financial statements. Accordingly, the analysis consists entirely of GAAP measurements, aside from the four sub-totals (see asterisks).

### Continuing Operations

As disclosed on the preceding chart, LREIT incurred a loss from continuing operations before taxes of \$20,461,027 during 2010, compared to a loss from continuing operations before taxes of \$12,967,629 during 2009, representing an increase in the loss from continuing operations before taxes of \$7,493,398. The increase in the loss mainly reflects a decrease in net operating income.

The decrease in operating income mainly reflects the decrease in operating income from the property portfolio in Fort McMurray, as a result of the decline in rental market conditions. The expiry of the "entire property" lease agreement at Lakewood Manor, effective May 31, 2010 and the associated rental abatement and rent credit, as well as the subsequent increase in the vacancy loss, also contributed to the reduction in operating income for the Fort McMurray property portfolio.

After including income from discontinued operations and future income tax expense, LREIT incurred a loss of \$6,278,907 during 2010, compared to an income of \$3,497,073 during 2009.



## Discontinued Operations

As disclosed in the preceding chart, LREIT generated income from discontinued operations of \$14,182,120 during 2010, compared to income of \$19,163,506 during 2009. The income from discontinued operations includes revenues, property operating costs, financing expenses, and amortization charges for all properties which are classified as "held for sale" at the end of the year; revenues, property operating costs, financing expenses, and amortization charges for the properties which were sold during the year (five properties in 2010 and 13 properties in 2009), and the total gain on sale in regard to the properties which were sold during the year.

Amortization charges for a specific property are discontinued, effective on the date in which the property was classified as "held for sale". As the majority of the "held for sale" properties were reclassified during the second and fourth quarter of 2009, amortization charges have a significant effect on the comparative results for discontinued operations.

The income from discontinued operations for 2010 includes amortization charges of \$204,396, whereas amortization charges for discontinued operations for 2009 amounted to \$2,993,088. Excluding amortization charges and the gain on sale, the Trust generated income from discontinued operations of \$1,712,814 during 2010, compared to \$1,092,709 during 2009. The increase of \$620,105 is mainly due to a decrease in income taxes payable.

In summary, the total decrease in income from discontinued operations during 2010 of \$4,981,386, reflects a decrease in the gain from property sales of \$8,390,183, partially offset by a decrease in amortization charges of \$2,788,692 and an increase in income before taxes of \$139,289 and a decrease in income taxes of \$480,816.

## Revenue

### Market Conditions

#### *Fort McMurray (13 properties)*

Accounting for approximately 74% of the total available rental units, the Fort McMurray property portfolio represents the most significant revenue component in LREIT's continuing operations.

As a result of the downturn in the global economy in October 2008, there was a reduction in the level of activity in the oil sands construction industry resulting in a weakening of rental market conditions in Fort McMurray. The decline in rental market conditions has resulted in lower rental rates and a reduction in occupancy levels of LREIT's property portfolio in Fort McMurray.

Although development activity in the oil sands industry is improving, the expectation is that the economic recovery in Fort McMurray may occur gradually.

An analysis of the average monthly rents and vacancy loss for the Fort McMurray portfolio and the other property portfolios of LREIT is provided in the following sections of this report.

#### *Yellowknife (Two Properties)*

Yellowknife has experienced a stable market for rental accommodation since the beginning of 2009. The overall vacancy rate has remained at a low level, and the average overall monthly rental rate for the Yellowknife rental market increased by 3.1% in 2010, compared to 2009.

*Other Locations (Four Properties)*

The four "other" properties consist of three residential rental properties and one commercial property. The commercial property is 100% leased to a single tenant until February 28, 2022. The overall vacancy loss for the three residential rental properties increased from 6% in 2009 to 8% in 2010, primarily due to an increase in the vacancy loss for the rental property in Edson, Alberta.

**Total Revenue****Analysis of Total Revenue**

|                                  | Total Revenues         |                      |                       |              |
|----------------------------------|------------------------|----------------------|-----------------------|--------------|
|                                  | Year Ended December 31 |                      | Increase (Decrease)   |              |
|                                  | 2010                   | 2009                 | Amount                | % of Total   |
| Income Properties:               |                        |                      |                       |              |
| Rental revenue                   | \$ 31,385,914          | \$ 39,662,949        | \$ (8,277,035)        | 107 %        |
| Interest and other income        | 233,271                | 364,859              | (131,588)             | 2 %          |
| Sub-total                        | 31,619,185             | 40,027,808           | (8,408,623)           | 109 %        |
| Trust: Interest and other income | 725,878                | 26,863               | 699,015               | (9)%         |
| Total                            | <u>\$ 32,345,063</u>   | <u>\$ 40,054,671</u> | <u>\$ (7,709,608)</u> | <u>100 %</u> |

The revenue of LREIT consists of "rental revenue" and "interest and other income". All of the revenue is generated from the portfolio of income properties, with the exception of the component of revenue which is derived from general Trust operations.

Revenue from Trust operations is classified as "interest and other income" and is comprised almost exclusively of interest income on mortgage loans receivable and cash.

As disclosed in the chart above, the total revenue of LREIT decreased by \$7,709,608, during 2010, compared to 2009, comprised of a \$8,408,623 decrease in revenue from income properties and \$699,015 increase in revenue from Trust operations. The decrease in revenue from income properties is comprised of a \$8,277,035 decrease in rental revenue and a \$131,588 decrease in interest and other income.

The increase in interest and other income from Trust-operations mainly reflects a higher average monthly balance of mortgage loans receivable during 2010, compared to 2009.

**Rental Revenue****Analysis of Total Revenue from Income Properties**

|               | Year Ended December 31 |                      |                       |              |              |              |
|---------------|------------------------|----------------------|-----------------------|--------------|--------------|--------------|
|               |                        |                      | Increase (Decrease)   |              | % of Total   |              |
|               | 2010                   | 2009                 | Amount                | %            | 2010         | 2009         |
| Fort McMurray | \$ 24,151,855          | \$ 32,753,694        | \$ (8,601,839)        | (26)%        | 76 %         | 82 %         |
| Yellowknife   | 5,425,290              | 5,191,838            | 233,452               | 4 %          | 17 %         | 13 %         |
| Other         | 2,042,040              | 2,082,276            | (40,236)              | (2)%         | 6 %          | 5 %          |
| Total         | <u>\$ 31,619,185</u>   | <u>\$ 40,027,808</u> | <u>\$ (8,408,623)</u> | <u>(21)%</u> | <u>100 %</u> | <u>100 %</u> |

As disclosed in the chart above, the total revenue from income properties decreased by \$8,408,623 during 2010, comprised of a decrease in revenue from the income properties in Fort McMurray of \$8,601,839, an increase in revenue from the Yellowknife portfolio of \$233,452 and a decrease in revenue from the Other portfolio of \$40,236.

The decrease in revenue from the Fort McMurray portfolio reflects an increase in the vacancy loss as well as a decrease in the average rental rate. As disclosed in the chart below, the average monthly vacancy loss for the Fort McMurray portfolio increased from 22% during 2009, to 32% during 2010, while the average monthly rental rate decreased by \$503 or 17.7%.

Due to a number of factors, including the timing of lease expiry dates and the time lag between the decline in general economic conditions and the slowdown of new construction activity in the oil sands industry, the increase in the vacancy loss for the Fort McMurray property portfolio occurred on a gradual basis in 2009. As disclosed in the chart below, the vacancy loss for the Fort McMurray property portfolio increased from 10% in the first quarter of 2009 to 31% in the fourth quarter of 2009. During 2010, the fluctuation in the quarterly vacancy loss was minimal, with the vacancy loss increasing from an average of 30% during the first half of the year to 33% during the second half of the year.

The increase in the vacancy loss for the Fort McMurray property portfolio in the second half of 2010 mainly reflects the expiry of the corporate lease agreement for Lakewood Manor effective May 31, 2010. Following the expiry of the lease agreement there was a marked increase in vacancy loss of Lakewood Manor and a corresponding increase in the average vacancy loss of the Fort McMurray property portfolio.

Given the current state of rental market conditions in Fort McMurray, the vacancy loss for the Fort McMurray property portfolio is expected to remain at, or near, current levels for the first half of 2011. Over time, the vacancy loss is expected to improve on a gradual basis, in the same manner as the vacancy loss gradually declined from the fourth quarter of 2008 to the third quarter of 2009.

#### Analysis of Vacancy Loss for Income Properties

|               | 2010 |      |      |      | 12 Month Average |
|---------------|------|------|------|------|------------------|
|               | Q1   | Q2   | Q3   | Q4   |                  |
| Fort McMurray | 30 % | 30 % | 33 % | 33 % | 32 %             |
| Yellowknife   | - %  | - %  | 1 %  | - %  | - %              |
| Other         | 9 %  | 9 %  | 7 %  | 7 %  | 8 %              |
| Total         | 25 % | 24 % | 27 % | 27 % | 26 %             |

  

|               | 2009 |      |      |      | 12 Month Average |
|---------------|------|------|------|------|------------------|
|               | Q1   | Q2   | Q3   | Q4   |                  |
| Fort McMurray | 10 % | 18 % | 30 % | 31 % | 22 %             |
| Yellowknife   | - %  | 1 %  | 1 %  | 0 %  | 1 %              |
| Other         | 2 %  | 5 %  | 7 %  | 8 %  | 6 %              |
| Total         | 9 %  | 15 % | 26 % | 26 % | 19 %             |

#### Analysis of Average Monthly Rents for Income Properties

|               | 2010    |         |         |         | 12 Month Average |
|---------------|---------|---------|---------|---------|------------------|
|               | Q1      | Q2      | Q3      | Q4      |                  |
| Fort McMurray | \$2,495 | \$2,143 | \$2,380 | \$2,338 | \$2,339          |
| Yellowknife   | \$1,941 | \$1,915 | \$1,936 | \$1,889 | \$1,923          |
| Other         | \$753   | \$761   | \$857   | \$858   | \$855            |
| Total         | \$2,114 | \$1,958 | \$2,135 | \$2,097 | \$2,103          |

  

|               | 2009    |         |         |         | 12 Month Average |
|---------------|---------|---------|---------|---------|------------------|
|               | Q1      | Q2      | Q3      | Q4      |                  |
| Fort McMurray | \$2,993 | \$2,904 | \$2,733 | \$2,595 | \$2,842          |
| Yellowknife   | \$1,810 | \$1,828 | \$1,990 | \$1,838 | \$1,865          |
| Other         | \$728   | \$739   | \$843   | \$844   | \$839            |
| Total         | \$2,530 | \$2,502 | \$2,400 | \$2,277 | \$2,461          |



### ***Rental Abatement and Rent Credit for Lakewood Manor***

Effective June 1, 2007, all of the units at Lakewood Manor were leased to a major oil sands company, pursuant to a three year lease agreement, under which the leasee was also responsible for all property operating costs. The lease agreement expired on May 31, 2010.

As disclosed in the 2010 Second and Third Quarter Reports, a provision for a rental abatement of \$325,000 and a rent credit of \$675,000 was established for the tenant during the second quarter of 2010, as result of a dispute regarding operating cost billings and other matters. The provision for the rental abatement and rent credit served to reduce rental revenue by \$1 Million in the second quarter of 2010. Pursuant to an agreement which was finalized subsequent to the second quarter, the rent credit is effective for a three year period ending May 31, 2013 and is to be applied against amounts owing on future accommodations.

## **Operating Costs**

### **Analysis of Operating Costs**

|               | Year Ended December 31 |                      | Increase (Decrease) |             |
|---------------|------------------------|----------------------|---------------------|-------------|
|               | 2010                   | 2009                 | Amount              | %           |
| Fort McMurray | \$ 9,411,743           | \$ 9,817,401         | \$ (405,658)        | (4)%        |
| Yellowknife   | 2,188,444              | 2,118,468            | 69,976              | 3 %         |
| Other         | 864,060                | 791,476              | 72,584              | 9 %         |
| Total         | <u>\$ 12,464,247</u>   | <u>\$ 12,727,345</u> | <u>\$ (263,098)</u> | <u>(2)%</u> |

During 2010, property operating costs for the portfolio decreased by \$263,098 or 2.1%, compared to 2009. The decrease is comprised of a \$405,658 decrease in the operating costs of the "Fort McMurray" property portfolio and an increase of \$69,976 and \$72,584 in the "Yellowknife" and "Other" property portfolios, respectively. The decrease in operating costs for the Fort McMurray portfolio is mainly due to decreased utility expenses and property management fees, both of which decreased primarily due to the increase in the vacancy rate in the Fort McMurray portfolio.

## **Net Operating Income and Operating Margin**

### **Analysis of Net Operating Income**

|               | Net Operating Income   |                      |                       |              |                  |              |                  |             |
|---------------|------------------------|----------------------|-----------------------|--------------|------------------|--------------|------------------|-------------|
|               | Year Ended December 31 |                      | Increase (Decrease)   |              | Percent of Total |              | Operating Margin |             |
|               | 2010                   | 2009                 | Amount                | %            | 2010             | 2009         | 2010             | 2009        |
| Fort McMurray | \$ 14,740,112          | \$ 22,936,293        | \$ (8,196,181)        | (36)%        | 74 %             | 84 %         | 61 %             | 70 %        |
| Yellowknife   | 3,236,846              | 3,073,370            | 163,476               | 5 %          | 16 %             | 11 %         | 60 %             | 59 %        |
| Other         | 1,177,980              | 1,290,800            | (112,820)             | (9)%         | 6 %              | 5 %          | 58 %             | 62 %        |
|               | 19,154,938             | 27,300,463           | (8,145,525)           | (30)%        | 96 %             | 100 %        | 61 %             | 68 %        |
| Trust         | <u>725,878</u>         | <u>26,863</u>        | <u>699,015</u>        | 2,602 %      | <u>4 %</u>       | <u>- %</u>   | <u>2 %</u>       | <u>- %</u>  |
| Total         | <u>\$ 19,880,816</u>   | <u>\$ 27,327,326</u> | <u>\$ (7,446,510)</u> | <u>(27)%</u> | <u>100 %</u>     | <u>100 %</u> | <u>63 %</u>      | <u>68 %</u> |

After considering the revenue and operating cost decreases as analysed in the preceding sections of this report, the net operating income (NOI) for the portfolio of income properties decreased by \$8,145,525 or 30% during 2010.

As with the decrease in revenue from income properties, the decrease in NOI is almost entirely attributable to a decrease in the NOI of the Fort McMurray portfolio. As disclosed in the chart above, the NOI of the Fort McMurray portfolio decreased by \$8,196,181 during 2010.

Overall, the operating margin for the property portfolio decreased from 68% during 2009, to 61% during 2010. The decline in the operating margin is primarily due to a decline in the profitability of the Fort McMurray property portfolio.

## Financing Expense

### Total Financing Expense

Financing expense encompasses mortgage loan interest, mortgage bond interest, interest on acquisition payable, convertible debenture interest, as well as a number of "non-cash" expenses, including amortization charges for transaction costs, accretion and the change in fair value of interest rate swaps.

Financing expense decreased by \$275,326 or 1% during 2010, compared to 2009. As disclosed in the following chart, the decrease is comprised of a \$2,252,315 decrease in mortgage loan financing expense, which includes a decrease in financing charges of \$5,005,420 relating to the change in value of interest swap agreements, a \$1,157,574 decrease in convertible debenture financing expense and a \$476,771 decrease in interest expense on acquisition payable, largely offset by \$3,556,749 of financing charges related to the mortgage bonds. During 2010, "non-cash" expenses decreased by \$1,286,613, compared to 2009.

#### Analysis of Financing Expense

|                                           | Year Ended December 31 |                      | Increase (Decrease) |             |
|-------------------------------------------|------------------------|----------------------|---------------------|-------------|
|                                           | 2010                   | 2009                 | Amount              | %           |
| <b>Mortgage Loans</b>                     |                        |                      |                     |             |
| Interest expense (1)                      | \$ 16,479,399          | \$ 14,738,704        | \$ 1,740,695        | 12 %        |
| Amortization of transaction costs (3)     | 1,546,802              | 534,392              | 1,012,410           | 189 %       |
| Change in value - interest rate swaps (4) | (2,711,625)            | 2,293,795            | (5,005,420)         | (218)%      |
| Total - mortgage loans                    | 15,314,576             | 17,566,891           | (2,252,315)         | (13)%       |
| <b>Mortgage Bonds</b>                     |                        |                      |                     |             |
| Interest expense (1)                      | 530,334                | -                    | 530,334             | - %         |
| Accretion (2)                             | 2,119,923              | -                    | 2,119,923           | - %         |
| Amortization of transaction costs (3)     | 906,492                | -                    | 906,492             | - %         |
| Total - mortgage bonds                    | 3,556,749              | -                    | 3,556,749           | - %         |
| <b>Acquisition Payable</b>                |                        |                      |                     |             |
| Interest expense (1)                      | 3,600,000              | 4,076,771            | (476,771)           | (12)%       |
| Total - acquisition payable               | 3,600,000              | 4,076,771            | (476,771)           | (12)%       |
| <b>Debentures</b>                         |                        |                      |                     |             |
| Interest expense (1)                      | 3,076,585              | 3,911,900            | (835,315)           | (21)%       |
| Accretion (2)                             | 2,617,912              | 2,853,290            | (235,378)           | (8)%        |
| Amortization of transaction costs (3)     | 572,706                | 659,587              | (86,881)            | (13)%       |
| Total - debentures                        | 6,267,203              | 7,424,777            | (1,157,574)         | (16)%       |
| <b>Defeased Liability</b>                 |                        |                      |                     |             |
| Interest expense (1)                      | 52,344                 | -                    | 52,344              | - %         |
| Amortization of transaction costs (3)     | 2,241                  | -                    | 2,241               | - %         |
| Total - defeased liability                | 54,585                 | -                    | 54,585              | - %         |
| <b>Total - financing expense</b>          | <u>\$ 28,793,113</u>   | <u>\$ 29,068,439</u> | <u>\$ (275,326)</u> | <u>(1)%</u> |

Financing expense is analyzed as follows:

|                                           |                      |                      |                     |              |
|-------------------------------------------|----------------------|----------------------|---------------------|--------------|
| <b>Interest expense (1)</b>               | <u>\$ 23,738,662</u> | <u>\$ 22,727,375</u> | <u>\$ 1,011,287</u> | <u>4 %</u>   |
| <b>Non-cash expense</b>                   |                      |                      |                     |              |
| Accretion (2)                             | 4,737,835            | 2,853,290            | 1,884,545           | 66 %         |
| Amortization of transaction costs (3)     | 3,028,241            | 1,193,979            | 1,834,262           | 154 %        |
| Change in value - interest rate swaps (4) | (2,711,625)          | 2,293,795            | (5,005,420)         | (218)%       |
| <b>Non-cash financing expense</b>         | <u>5,054,451</u>     | <u>6,341,064</u>     | <u>(1,286,613)</u>  | <u>(20)%</u> |
| <b>Total - financing expense</b>          | <u>\$ 28,793,113</u> | <u>\$ 29,068,439</u> | <u>\$ (275,326)</u> | <u>(1)%</u>  |

## **Interest Expense**

### ***Interest Expense - Mortgage Loans***

Mortgage loan interest increased by \$1,740,695 or 12% during 2010, compared to 2009. The increase mainly reflects an increase in the weighted average interest rate for variable rate mortgage loans. The reduction in the amount of mortgage loans payable debt in 2010 served to partially offset the impact of higher interest rates.

Interest expense associated with Parsons Landing is reflected in "interest on acquisition payable", as noted below.

### ***Interest on Acquisition Payable***

During 2010, interest on acquisition payable decreased by \$476,771. The decrease is mainly related to the commencement date for the forgiveness of interest. The original payment date for the amount owing on Parsons Landing was February 28, 2009. During 2009, interest on acquisition payable is comprised of the \$300,000 monthly payments for the ten month period commencing March 1, 2009, plus accrued interest on the entire amount owing for the period from January 1, 2009 to February 28, 2009. During 2010, interest on acquisition payable is comprised of 12 monthly payments of \$300,000.

### ***Interest Expense - Mortgage Bonds***

During 2010, interest on the mortgage bonds amounted to \$530,334. Interest on mortgage bonds commenced on March 9, 2010 at a rate of 9%, upon the closing date of the first mortgage bond offering. The face value of the mortgage bonds was: (i) \$6.78 Million from March 9, 2010 to October 31, 2009; (ii) \$2.63 Million from November 1, 2010 to December 22, 2010; and (iii) \$12,637,000 from December 23, 2010 to year end.

### ***Interest Expense - Debentures***

During 2010, interest on convertible debentures decreased by \$835,315 or 21%, compared to 2009. The decrease mainly reflects the retirement of \$11.95 Million of Series E Convertible Debentures in February 2010.

### ***Total Interest Expense***

During 2010, total interest expense increased by \$1,011,287 or 4%, compared to 2009.

### ***Interest Expense Ratio***

As a percentage of operating income from continuing operations, total interest in regard to mortgage loans and acquisition payable, increased from 69% during 2009 to 101% during 2010.

The increase in the ratio of mortgage loan and acquisition payable interest, relative to operating income from continuing operations, reflects the decrease in operating income from continuing operations during 2010, as well as the net increase in interest on mortgage loans payable debt and the acquisition payable.

After including interest on convertible debentures and mortgage bonds, the ratio of interest expense, relative to operating income from continuing operations, is 119% for 2010, compared to 83% for 2009.



## **Non-cash Financing Expenses**

### ***Summary***

As indicated in the preceding chart, non-cash financing expenses decreased from \$6,341,064 in 2009 to \$5,054,451 in 2010. The decrease was comprised of a \$5,005,420 decrease in the swap asset financing expense offset by an increase in accretion expenses and amortization of transaction costs expenses of \$1,884,545 and \$1,834,262, respectively.

### ***Accretion***

Accretion is comprised of accretion expenses relating to the convertible debentures and mortgage bonds. The increase in accretion expense is mainly attributable to a one time charge of \$1,895,913 upon repayment of the March 9, 2010 mortgage bonds.

### ***Amortization of Transaction Costs***

Transaction costs related to mortgage loans payable debt, mortgage bond debt, convertible debenture debt and certain other financial instruments are capitalized and expensed through amortization charges.

The increase in amortization of transaction costs is mainly attributable to a one time charge of \$838,423 upon the repayment of the March 9, 2010 mortgage bonds and charges of \$692,482 in regard to transaction costs related to mortgage loans with covenant breaches.

Amortization charges represent a "non-cash" expense and are excluded from the determination of cash flow from operating activities. The actual cash outlay in regard to transaction costs for continuing operations is included in the determination of cash flow from financing activities.

### ***Change in Value of Interest Rate Swaps***

As disclosed in the preceding chart, the decrease in financing expense for 2010 includes a decrease in the amount related to the change in value of the "interest rate swaps" of \$5,005,420.

During 2008, LREIT entered into interest rate swap arrangements whereby the interest rate on two floating rate mortgages were fixed for the five and ten year terms of the mortgages. The main purpose of the interest rate swap arrangement is to reduce the risk associated with floating interest rates. In accordance with GAAP, the interest rate swap agreements are derivative financial instruments and are recorded at "fair value" on the balance sheet of the Trust. Changes in fair value are recognized as earnings/losses through charges to financing expense. Increases in fair value serve to decrease financing expense, while decreases in fair value serve to increase financing expense.

In very general terms, the fair value of the interest rate swaps is based on the difference between the net present value of projected payments under the fixed rate mortgages, compared to the net present value of projected payments under the floating rate mortgages. As a result of the decline in market interest rates, the fair value of the interest rate swap arrangements decreased by \$2,293,795 during 2009. During 2010, the fair value of the interest rate swap arrangements increased by \$2,711,625, as market interest rates over the course of the year, were higher in 2010 than in 2009.

Although the change in the fair value of the interest rate swaps served to decrease financing expense during 2010, the change in value is a non-cash transaction which is excluded from the determination of the operating cash flow of the Trust. As a result of fluctuations in market interest rates, the fair value of the interest rate swaps may change significantly in the future, however, the change in value has no impact on cash outflows throughout the entire term of the swap agreements. The change in value provides an indication of the relative benefit of a fixed rate mortgage, compared to a variable rate mortgage, during a specified period of time.

## Trust Expense

Trust expense increased by \$275,047 during 2010, compared to 2009. The increase mainly reflects prepayment discounts of \$250,000 on the settlement of two mortgage loan receivables as well as an increase in professional fees of \$192,242, partially offset by a decrease in the service fees of Shelter Canadian.

During 2010, the Trust incurred \$145,731 in audit and consulting fees relating to the implementation of International Financial Reporting Standards.

During 2010, the service fee of Shelter Canadian decreased by \$209,376 compared to 2009. The service fee of Shelter Canadian is in regard to administrative and asset management services and is equal to 0.3% of the gross book value of the assets of LREIT, excluding cash and defeasance assets, as of the date of the most recently issued financial statements. The decrease in the fee reflects a net book asset value which, on a monthly average basis, was lower in 2010 than in 2009.

Please refer to "Related Party Transactions" for additional information in regard to the administrative, asset management and property management services which are provided to LREIT by Shelter Canadian Properties Limited and the associated remuneration.

Trust expense also includes unit-based compensation expense pertaining to the Unit Option Plan and the Deferred Unit Plan. Additional information regarding the Unit Option Plan and the Deferred Unit Plan is provided on Schedule II of this report.

## Amortization Expense

During 2010, amortization expense increased by \$47,167 or 1%, compared to 2009. The increase mainly reflects amortization charges on improvements to income properties. Amortization charges for transaction costs are recorded as a financing expense on the Consolidated Statement of Loss and Comprehensive Loss.

## Future Income Taxes

In accordance with generally accepted accounting principles, LREIT has recorded a future income tax asset based on the temporary difference between the accounting and tax basis of assets held by the Trust, net of a valuation allowance to recognize the uncertainty of the realization of the future income tax asset. During 2009 and 2010, the valuation allowance served to reduce the future income tax asset, to nil.

The estimate of the future income tax assets and liabilities is subject to periodic change. To the extent that the net future income tax position increases or decreases, there is a corresponding increase or decrease in the future income tax expense or recovery of the Trust, with the increase or decrease having a direct impact on bottom-line results.

As of December 31, 2010, a valuation allowance of \$4,118,856 has been recorded in recognition of the uncertainty of realization of the future income tax asset, which arises from the temporary differences between the accounting and tax basis of assets held in the Trust, which are expected to reverse after 2010. As a result, the future income tax asset and future income tax expense are reflected as nil.

Assets and liabilities of properties held for sale reflect future income tax assets and liabilities using the considerations outlined in the preceding paragraph.

A discussion on the change in tax treatment effective January 1, 2011, is disclosed in this report under "Taxation".

## Comparison to Preceding Quarter

### Analysis of Loss Fourth Quarter 2010 vs. Third Quarter 2010

|                                                                   | Three Months Ended    |                     | Increase (Decrease)   |                 |
|-------------------------------------------------------------------|-----------------------|---------------------|-----------------------|-----------------|
|                                                                   | December 31, 2010     | September 30, 2010  | Amount                | %               |
| Rental revenue                                                    | \$ 7,592,215          | \$ 7,759,469        | \$ (167,254)          | (2.2)%          |
| Interest and other income                                         | 423,237               | 172,433             | 250,804               | 145.5 %         |
| Property operating costs                                          | 3,092,880             | 2,865,297           | 227,583               | 7.9 %           |
| Net Operating Income (NOI)                                        | 4,922,572             | 5,066,605           | (144,033)             | (2.8)%          |
| Trust expense                                                     | 723,855               | 657,467             | 66,388                | 10.1 %          |
| Income before financing expense, amortization, and taxes (EBITDA) | 4,198,717             | 4,409,138           | (210,421)             | (4.8)%          |
| Financing expense                                                 | 10,547,966            | 5,713,882           | 4,834,084             | 84.6 %          |
| Income (loss) before amortization                                 | (6,349,249)           | (1,304,744)         | (5,044,505)           | 386.6 %         |
| Amortization                                                      | 2,130,105             | 2,129,770           | 335                   | - %             |
| Loss from continuing operations for the period                    | (8,479,354)           | (3,434,514)         | (5,044,840)           | 146.9 %         |
| Income from discontinued operations for the period                | 1,244,612             | 4,691,563           | (3,446,951)           | (73)%           |
| Income (loss) and comprehensive income (loss) for the period      | <u>\$ (7,234,742)</u> | <u>\$ 1,257,049</u> | <u>\$ (8,491,791)</u> | <u>(675.5)%</u> |

## Overview

During the fourth quarter of 2010, LREIT incurred a loss from continuing operations of \$8,479,354, compared to a loss from continuing operations of \$3,434,514 during the third quarter of 2010, representing an increase in the loss from continuing operations of \$5,044,840. The increase in the loss from continuing operations mainly reflects an increase in financing expense of \$4,834,084.

The increase in financing expense mainly reflects the following factors:

- an increase in accretion of \$1,895,913 and an increase in amortization of \$838,423 related to the repayment of the March 2010 mortgage bonds;
- a decrease in the amount of the financing expense reduction related to the change in value of interest rate swap arrangements of \$1,078,277; and
- an increase in amortization charges in regard to mortgage loans payable debt of \$829,490, the majority of which pertains to the amortization of fees which were incurred on the mortgage loans that are in breach of debt service coverage requirements.

All of the above-noted expenses are part of the non-cash component of financing expense. After excluding the non-cash component, financing expense increased by \$123,314 during the fourth quarter of 2010.

During the fourth quarter of 2010, net operating income decreased by \$144,033, mainly due to a decrease in the net operating income of the Fort McMurray property portfolio, largely offset by an increase in interest and other income from Trust operations. As disclosed in the analysis which follows this commentary, the net operating income of the Fort McMurray property portfolio decreased by \$424,760 during the fourth quarter of 2010.

The decrease in the net operating income for the Fort McMurray portfolio mainly reflects increased utility expenses and reduced rental revenue.



After providing for income from discontinued operations, LREIT completed the fourth quarter of 2010 with a loss of \$7,234,742, compared to an income of \$1,257,049 during the third quarter of 2010. The bottom-line results for the fourth quarter of 2010 reflect income from discontinued operations of \$1,244,612, compared to \$4,691,563 during the third quarter of 2010. Excluding the \$834,488 relating to gains on sale during the fourth quarter of 2010, compared to \$4,247,095 in the third quarter of 2010, income from discontinued operations was \$410,124 compared to \$444,468 in the third quarter.

### Revenue and NOI Analysis

The following analysis provides comparative results for the fourth quarter of 2010, compared to both the third quarter of 2010 and the second quarter of 2010, for the income-producing properties of LREIT. The analysis excludes interest and other income pertaining to "Trust" operations.

|                            | 2010                |                     |                        |                     |                        |
|----------------------------|---------------------|---------------------|------------------------|---------------------|------------------------|
|                            | Q4                  | Q3                  | Increase<br>(Decrease) | Q2                  | Increase<br>(Decrease) |
| Total revenue              |                     |                     |                        |                     |                        |
| Fort McMurray              | \$ 5,750,417        | \$ 5,970,350        | \$ (219,933)           | \$ 5,740,767        | \$ 9,650               |
| Yellowknife                | 1,321,729           | 1,343,524           | (21,795)               | 1,404,041           | (82,312)               |
| Other                      | 517,398             | 523,031             | (5,633)                | 507,983             | 9,415                  |
| Sub-total                  | 7,589,544           | 7,836,905           | (247,361)              | 7,652,791           | (63,247)               |
| Trust                      | 425,908             | 94,997              | 330,911                | 114,573             | 311,335                |
| Total revenue              | <u>\$ 8,015,452</u> | <u>\$ 7,931,902</u> | <u>\$ 83,550</u>       | <u>\$ 7,767,364</u> | <u>\$ 248,088</u>      |
| Net operating income       |                     |                     |                        |                     |                        |
| Fort McMurray              | \$ 3,390,541        | \$ 3,815,301        | \$ (424,760)           | \$ 3,514,323        | \$ (123,782)           |
| Yellowknife                | 753,279             | 868,070             | (114,791)              | 843,280             | (90,001)               |
| Other                      | 352,844             | 288,237             | 64,607                 | 298,356             | 54,488                 |
| Sub-total                  | 4,496,664           | 4,971,608           | (474,944)              | 4,655,959           | (159,295)              |
| Trust                      | 425,908             | 94,997              | 330,911                | 108,573             | 317,335                |
| Total net operating income | <u>\$ 4,922,572</u> | <u>\$ 5,066,605</u> | <u>\$ (144,033)</u>    | <u>\$ 4,764,532</u> | <u>\$ 158,040</u>      |

### Summary of Quarterly Results

#### Quarterly Analysis

|                                                                 | 2010           |                |                  |                  |
|-----------------------------------------------------------------|----------------|----------------|------------------|------------------|
|                                                                 | Q4             | Q3             | Q2<br>(restated) | Q1<br>(restated) |
| Total revenue                                                   | \$ 8,015,452   | \$ 7,931,902   | \$ 7,767,364     | \$ 8,630,346     |
| Net operating income                                            | \$ 4,922,572   | \$ 5,066,605   | \$ 4,764,532     | \$ 5,127,107     |
| Loss from continuing operations,<br>before future income tax    | \$ (8,479,354) | \$ (3,434,514) | \$ (4,548,216)   | \$ (3,998,943)   |
| Income (loss) and comprehensive<br>income (loss) for the period | \$ (7,234,742) | \$ 1,257,049   | \$ (3,931,234)   | \$ 3,630,020     |

#### PER UNIT

|                                                                 |            |            |            |            |
|-----------------------------------------------------------------|------------|------------|------------|------------|
| Net operating income                                            |            |            |            |            |
| - basic                                                         | \$ 0.268   | \$ 0.277   | \$ 0.261   | \$ 0.283   |
| - diluted                                                       | \$ 0.206   | \$ 0.213   | \$ 0.200   | \$ 0.215   |
| Loss from continuing operations<br>before future income tax     |            |            |            |            |
| - basic                                                         | \$ (0.462) | \$ (0.188) | \$ (0.249) | \$ (0.221) |
| - diluted                                                       | \$ (0.462) | \$ (0.188) | \$ (0.249) | \$ (0.221) |
| Income (loss) and comprehensive<br>income (loss) for the period |            |            |            |            |
| - basic                                                         | \$ (0.394) | \$ 0.069   | \$ (0.216) | \$ 0.200   |
| - diluted                                                       | \$ (0.394) | \$ 0.069   | \$ (0.216) | \$ 0.200   |

**Quarterly Analysis**

|                                                                                      | 2009             |                  |                  |                  |
|--------------------------------------------------------------------------------------|------------------|------------------|------------------|------------------|
|                                                                                      | Q4<br>(restated) | Q3<br>(restated) | Q2<br>(restated) | Q1<br>(restated) |
| Total revenue                                                                        | \$ 8,460,620     | \$ 8,966,037     | \$ 10,589,265    | \$ 12,038,750    |
| Net operating income                                                                 | \$ 5,470,624     | \$ 5,882,898     | \$ 7,580,670     | \$ 8,393,134     |
| Income (loss) from continuing operations<br>for the period, before future income tax | \$ (1,445,050)   | \$ (3,455,122)   | \$ (3,696,021)   | \$ (4,371,440)   |
| Loss and comprehensive loss for the period                                           | \$ 19,131,118    | \$ (3,146,599)   | \$ (3,956,727)   | \$ (8,530,719)   |

**PER UNIT**

|                                                                                      |            |            |            |            |
|--------------------------------------------------------------------------------------|------------|------------|------------|------------|
| Net operating income                                                                 |            |            |            |            |
| - basic                                                                              | \$ 0.307   | \$ 0.334   | \$ 0.434   | \$ 0.480   |
| - diluted                                                                            | \$ 0.218   | \$ 0.230   | \$ 0.300   | \$ 0.333   |
| Income (loss) from continuing operations<br>for the period, before future income tax |            |            |            |            |
| - basic                                                                              | \$ (0.081) | \$ (0.196) | \$ (0.212) | \$ (0.250) |
| - diluted                                                                            | \$ (0.081) | \$ (0.196) | \$ (0.212) | \$ (0.250) |
| Loss and comprehensive loss for the period                                           |            |            |            |            |
| - basic                                                                              | \$ 1.072   | \$ (0.179) | \$ (0.227) | \$ (0.488) |
| - diluted                                                                            | \$ 1.072   | \$ (0.179) | \$ (0.227) | \$ (0.488) |

**Notes**

(1) The restatement of the quarterly results reflects a reduction to total revenue, net operating income, income (loss) from continuing operations pertaining to discontinued operations.

**Income (Loss) Per Unit****Analysis of Income (Loss) per Unit**

|                                                                    | Year Ended December 31 |            |            |        |
|--------------------------------------------------------------------|------------------------|------------|------------|--------|
|                                                                    | 2010                   | 2009       |            | Change |
| Income (loss) and comprehensive income (loss)                      |                        |            |            |        |
| - basic                                                            | \$ (0.344)             | \$ 0.199   | \$ (0.543) | (273)% |
| - diluted                                                          | \$ (0.344)             | \$ 0.199   | \$ (0.543) | (273)% |
| Income (loss) from continuing operations, before future income tax |                        |            |            |        |
| - basic                                                            | \$ (1.120)             | \$ (0.739) | \$ (0.381) | (52)%  |
| - diluted                                                          | \$ (1.120)             | \$ (0.739) | \$ (0.381) | (52)%  |

LREIT incurred a loss of \$0.344 per unit during 2010, compared to an income of \$0.199 per unit during 2009. The change in the per unit results mainly reflects the net income/loss results of the Trust. The per unit results were also partially affected by an increase in the weighted average number of units during 2010. During 2010, the weighted average number of units increased by 726,366 units or 4.14%. The increase reflects the exchange of Village West Class B units upon the sale of Village West in November 2009, and the vesting of the deferred units granted to Trustees.

## ANALYSIS OF CASH FLOWS

### Operating Activities

#### Cash from Operating Activities

|                                                                                                           | Year Ended December 31 |                     | Increase<br>(Decrease) |
|-----------------------------------------------------------------------------------------------------------|------------------------|---------------------|------------------------|
|                                                                                                           | 2010                   | 2009                |                        |
| <b>Continuing Operations</b>                                                                              |                        |                     |                        |
| Rental revenue                                                                                            | \$ 31,385,914          | \$ 39,662,949       | \$ (8,277,035)         |
| Interest and other income                                                                                 | 959,149                | 391,722             | 567,427                |
| Property operating costs                                                                                  | 12,464,247             | 12,727,345          | (263,098)              |
| Net operating income (NOI)                                                                                | 19,880,816             | 27,327,326          | (7,446,510)            |
| Less:                                                                                                     |                        |                     |                        |
| Financing expense                                                                                         | 28,793,113             | 29,068,439          | (275,326)              |
| Non-cash component of financing expense (1)                                                               | 5,054,451              | 6,341,064           | (1,286,613)            |
|                                                                                                           | 23,738,662             | 22,727,375          | 1,011,287              |
| Trust expense                                                                                             | 3,035,583              | 2,760,536           | 275,047                |
| Non-cash component of trust expense                                                                       | 426,271                | 282,449             | 143,822                |
|                                                                                                           | 2,609,312              | 2,478,087           | 131,225                |
| Cash provided by (used in) operating activities, before changes in non-cash operating activities          | (6,467,158)            | 2,121,864           | (8,589,022)            |
| Changes in non-cash operating items                                                                       | 2,246,300              | 1,356,144           | 890,156                |
| Cash provided by (used in) operating activities - continuing operations                                   | <u>\$ (4,220,858)</u>  | <u>\$ 3,478,008</u> | <u>\$ (7,698,866)</u>  |
| <b>Discontinued Operations</b>                                                                            |                        |                     |                        |
| Cash provided by operating activities, excluding leasing activity and changes in non-cash operating items | \$ 2,432,788           | \$ 2,981,255        | \$ (548,467)           |
| Cash used in leasing activities                                                                           | -                      | (683,746)           | 683,746                |
| Cash provided by operating activities, before changes in non-cash operating items                         | 2,432,788              | 2,297,509           | 135,279                |
| Changes in non-cash operating items                                                                       | (44,757)               | (3,174,216)         | 3,129,459              |
| Cash provided by (used in) operating activities                                                           | <u>\$ 2,388,031</u>    | <u>\$ (876,707)</u> | <u>\$ 3,264,738</u>    |
| <b>Summary</b>                                                                                            |                        |                     |                        |
| Cash provided by (used in) operating activities, before changes in non-cash operating items               | \$ (6,467,158)         | \$ 2,121,864        | \$ (8,589,022)         |
| -continuing operations                                                                                    | 2,432,788              | 2,297,509           | 135,279                |
| -discontinued operations                                                                                  |                        |                     |                        |
| Total - continuing and discontinued operations                                                            | <u>\$ (4,034,370)</u>  | <u>\$ 4,419,373</u> | <u>\$ (8,453,743)</u>  |
| Cash provided by (used in) operating activities                                                           | \$ (4,220,858)         | \$ 3,478,008        | \$ (7,698,866)         |
| -continuing operations                                                                                    | 2,388,031              | (876,707)           | 3,264,738              |
| -discontinued operations                                                                                  |                        |                     |                        |
| Total - continuing and discontinued operations                                                            | <u>\$ (1,832,827)</u>  | <u>\$ 2,601,301</u> | <u>\$ (4,434,128)</u>  |

- (1) The cash component of financing expense reflects mortgage loan interest, convertible debenture and mortgage bond interest, as well as interest on the amount payable for Parsons Landing, and is calculated by excluding amortization charges for transaction costs, the change in value of interest rate swaps and the accretive portion of the debt component of convertible debentures and mortgage bonds. An analysis of the cash component of financing expense (i.e., "total interest expense") is provided in the preceding analysis of "Financing Expense".



### Continuing Operations

During 2010, the operating activities from the continuing operations of LREIT resulted in a net cash outflow of \$4,220,858. After excluding changes in non-cash operating items, cash from operating activities decreased by \$8,589,022 during 2010, compared to 2009. The decrease in cash flow reflects a \$7.4 Million decrease in net operating income and a \$1.0 Million increase in the cash component of financing expense.

### Discontinued Operations

During 2010, "operating" cash flow from discontinued operations, before changes in non-cash operating items, increased by \$135,279, compared to 2009. The increase generally corresponds to the increase in income from discontinued operations, excluding the gain on property sales, amortization charges, non-controlling interest and leasing expenditures.

### Comparison to Third Quarter of 2010

#### Cash from Operating Activities

|                                                                                                           | Three Months Ended  |                      | Increase<br>(Decrease) |
|-----------------------------------------------------------------------------------------------------------|---------------------|----------------------|------------------------|
|                                                                                                           | December 31<br>2010 | September 30<br>2010 |                        |
| <b>Continuing Operations</b>                                                                              |                     |                      |                        |
| Rental revenue                                                                                            | \$ 7,592,214        | \$ 7,759,469         | \$ (167,255)           |
| Interest and other income                                                                                 | 423,237             | 172,433              | 250,804                |
| Property operating costs                                                                                  | 3,092,880           | 2,865,297            | 227,583                |
| Net operating income (NOI)                                                                                | 4,922,571           | 5,066,605            | (144,034)              |
| Less:                                                                                                     |                     |                      |                        |
| Financing expense                                                                                         | 10,547,966          | 5,713,882            | 4,834,084              |
| Non-cash component of financing expense                                                                   | 4,493,309           | (217,461)            | 4,710,770              |
|                                                                                                           | 6,054,657           | 5,931,343            | 123,314                |
| Trust expense                                                                                             | 723,855             | 657,467              | 66,388                 |
| Non-cash component of trust expense                                                                       | 63,518              | 30,758               | 32,760                 |
|                                                                                                           | 660,337             | 626,709              | 33,628                 |
|                                                                                                           | (1,792,423)         | (1,491,447)          | (300,976)              |
| Changes in non-cash operating items                                                                       | 908,981             | 1,124,651            | (215,670)              |
| Cash provided by (used in) operating activities - continuing operations                                   | \$ (883,442)        | \$ (366,796)         | \$ (516,646)           |
| <b>Discontinued Operations</b>                                                                            |                     |                      |                        |
| Cash provided by operating activities, excluding leasing activity and changes in non-cash operating items | \$ 393,389          | \$ 703,670           | \$ (310,281)           |
| Cash used in leasing activities                                                                           | -                   | -                    | -                      |
| Cash provided by operating activities, before changes in non-cash operating items                         | 393,389             | 703,670              | (310,281)              |
| Changes in non-cash operating items                                                                       | (783,521)           | (1,093,678)          | 310,157                |
| Cash provided by operating activities                                                                     | \$ (390,132)        | \$ (390,008)         | \$ (124)               |
| <b>Summary</b>                                                                                            |                     |                      |                        |
| Cash provided by (used in) operating activities, before changes in non-cash operating items               |                     |                      |                        |
| -continuing operations                                                                                    | \$ (1,792,423)      | \$ (1,491,447)       | \$ (300,976)           |
| -discontinued operations                                                                                  | 393,389             | 703,670              | (310,281)              |
| Total - continuing and discontinued operations                                                            | \$ (1,399,034)      | \$ (787,777)         | \$ (611,257)           |
| Cash provided by (used in) operating activities                                                           |                     |                      |                        |
| -continuing operations                                                                                    | \$ (883,442)        | \$ (366,796)         | \$ (516,646)           |
| -discontinued operations                                                                                  | (390,132)           | (390,008)            | (124)                  |
| Total - continuing and discontinued operations                                                            | \$ (1,273,574)      | \$ (756,804)         | \$ (516,770)           |

**Continuing Operations**

During the fourth quarter of 2010, cash provided by operating activities, before changes in non-cash operating items, decreased by \$300,976, compared to the third quarter of 2010. The cash flow results for the fourth quarter compared to the third quarter generally correspond to the income results for continuing operations for the fourth quarter after excluding the non-cash component of financing expense.

**Discontinued Operations**

During the fourth quarter of 2010, "operating" cash flow from discontinued operations, before changes in non-cash operating items, decreased by \$310,281, compared to the third quarter of 2010.

**Funds from Operations ("FFO") & Adjusted Funds from Operations ("AFFO")**

LREIT considers "Funds from Operations" ("FFO") and "Adjusted Funds from Operations" ("AFFO") to be meaningful additional measures of operating performance. FFO measures the cash generating abilities of LREIT, while AFFO is indicative of available cash flow after capital reinvestment transactions.

During 2010, FFO decreased by \$7,699,336, compared to 2009, while AFFO decreased by \$9,898,541. On a basic per unit basis, FFO decreased by \$0.416 per unit, while AFFO decreased by \$0.546 per unit.

The operating cash flow from discontinued operations before changes in non-cash operating items is included in the calculation of FFO and AFFO.

**Funds from Operations/Adjusted Funds from Operations \***

|                                                                                  | Year Ended December 31 |                     |
|----------------------------------------------------------------------------------|------------------------|---------------------|
|                                                                                  | 2010                   | 2009                |
| Income (loss)                                                                    | \$ (6,278,907)         | \$ 3,497,073        |
| Add (deduct):                                                                    |                        |                     |
| Amortization expense - continuing operations                                     | 8,513,147              | 8,465,980           |
| Amortization expense - discontinued operations                                   | 204,396                | 2,993,088           |
| Future income tax - continuing operations                                        | -                      | 2,698,804           |
| Future income tax - discontinued operations                                      | 111,527                | 385,008             |
| Non-controlling interest* - discontinued operations                              | -                      | 599,729             |
| Gain on sale - discontinued operations                                           | (12,673,702)           | (21,063,885)        |
| <b>Funds from operations *</b>                                                   | <b>(10,123,539)</b>    | <b>(2,424,203)</b>  |
| Add (deduct):                                                                    |                        |                     |
| Straight-line rent adjustment - discontinued operations                          | 164,736                | (9,684)             |
| Net amortization of above/below market in-place leases - discontinued operations | -                      | 2,788               |
| Accretion of debt component of convertible debentures and mortgage bonds payable | 4,737,835              | 2,853,290           |
| Unit-based compensation                                                          | 176,271                | 282,449             |
| Change in fair value of interest rate swaps                                      | (2,711,625)            | 2,293,795           |
| Tenant inducement and leasing expenses - discontinued operations                 | -                      | (683,746)           |
| Ongoing improvements to income properties - continuing operations                | (198,533)              | (197,366)           |
| Ongoing improvements to income properties - discontinued operations              | (44,505)               | (218,142)           |
| <b>Adjusted funds from operations *</b>                                          | <b>\$ (7,999,360)</b>  | <b>\$ 1,899,181</b> |
| FFO per unit *                                                                   |                        |                     |
| - basic                                                                          | \$ (0.554)             | \$ (0.138)          |
| - diluted                                                                        | \$ (0.554)             | \$ (0.138)          |
| AFFO per unit *                                                                  |                        |                     |
| - basic                                                                          | \$ (0.438)             | \$ 0.108            |
| - diluted                                                                        | \$ (0.438)             | \$ 0.108            |

\* FFO and AFFO are non-GAAP financial measures of operating performance widely used by the real estate industry. Accordingly, FFO and AFFO should not be construed as an alternative to net income or cash flow from operating activities determined in accordance with GAAP.

FFO and AFFO have been calculated in accordance with the recommendations of RealPac, however, the method that is used by LREIT for calculating FFO and AFFO may differ from other issuers' methods and accordingly, may not be comparable with measures used by other issuers. The FFO and AFFO per unit amounts have been calculated on a basis consistent with that prescribed by GAAP for calculating earnings per unit.

## Distributable Income

Distributable income is a financial measurement which is commonly used to assess the cash distribution capabilities and cash flows of investment trusts and, as such, management believes that the disclosure of distributable income provides useful information to investors. Distributable income does not have any standardized meaning prescribed by GAAP and, therefore, the method that is used by LREIT for calculating distributable income may not be comparable to similar measures presented by other issuers. The most directly comparable GAAP measurement of the cash flows of LREIT is "cash from operating activities", as disclosed in the Consolidated Statement of Cash Flows in the financial statements. Accordingly, a reconciliation between cash from operating activities and distributable income is provided in the chart below.

### Reconciliation Between Cash from Operating Activities and Distributable Income

|                                                                                     | Year Ended December 31 |                     |
|-------------------------------------------------------------------------------------|------------------------|---------------------|
|                                                                                     | 2010                   | 2009                |
| Cash provided by continuing operating activities                                    | \$ (4,220,858)         | \$ 3,478,008        |
| Changes in non-cash operating items                                                 | <u>(2,246,300)</u>     | <u>(1,356,144)</u>  |
|                                                                                     | (6,467,158)            | 2,121,864           |
| Add (deduct):                                                                       |                        |                     |
| Cash flow from discontinued operations - net of changes in non-cash operating items | 2,432,788              | 2,297,509           |
| Difference between contract/market rates                                            | 57,820                 | 52,978              |
| Tenant inducement and leasing expenses                                              | -                      | 683,746             |
| Amortization of tenant inducement and leasing expenses                              | <u>(19,174)</u>        | <u>(127,493)</u>    |
| Distributable income (loss)                                                         | <u>\$ (3,995,724)</u>  | <u>\$ 5,028,604</u> |
| Per unit                                                                            |                        |                     |
| - Basic                                                                             | \$ (0.219)             | \$ 0.287            |
| - Diluted                                                                           | \$ (0.219)             | \$ 0.287            |

Changes in non-cash operating items are excluded from LREIT's calculation of distributable income as non-cash operating items are subject to significant temporary fluctuations which are typically reversed over time, mainly due to timing differences in accounts receivable and accounts payable.

The operating cash flow from discontinued operations net of changes in non-cash items is included in the calculation of distributable income. For discontinued operations, lease acquisition costs are also excluded from the calculation of distributable income, as leasing costs are subject to significant fluctuation based on leasing activity, while amortization charges for lease acquisition costs are deducted as amortization charges are more representative of the average annual cost of leasing acquisition activities.

During 2010, distributable income decreased by \$9,024,328 compared to 2009. The decrease in distributable income generally coincides with the total decrease in cash provided by operating activities from continuing and discontinued operations, excluding changes in non-cash operating items.



## **Cash Distributions**

For the months of January and February 2009, LREIT declared a cash distribution of \$0.04667 per unit, representing a total cash distribution of \$0.9334 per unit. The distribution for January and February 2009 amounted to a total cash outlay of \$1,564,021, including the distribution paid on the limited partnership units of the Village West Limited Partnership. Subsequent to the payment of the distribution for February 2009, LREIT suspended cash distributions due to the decline in rental market conditions in Fort McMurray and the impact on operating cash flow.

After considering the value of units issued under the distribution reinvestment plan the total distributions declared in 2009 amounted to \$1,668,364, excluding the "special" year end distribution which was paid in the form of trust units. LREIT did not declare any distributions in 2010, aside from the "special" year end distribution.

Cash distributions will continue to be suspended for the foreseeable future, given the other funding priorities of LREIT.

## **CAPITAL RESOURCES AND LIQUIDITY**

### **Source and Use of Funds - General**

Pending an improvement in rental housing market conditions in Fort McMurray, it is anticipated that LREIT will continue to require a source of cash to fund the cash deficiency from operating activities. LREIT also requires an ongoing source of cash to fund regular mortgage loan principal payments (classified as a "financing activity") and improvements to income properties (classified as an "investing activity"). In addition, LREIT requires additional capital on a periodic basis to fund lump-sum convertible debenture and mortgage bond repayments. As distributions on units were suspended subsequent to February 2009, the current funding requirements of LREIT do not encompass the funding of distributions.

The net cash inflow from the divestiture program and the "operation" of held for sale properties, as reflected under discontinued operations, effectively represents the primary funding source for the net cash deficiency from operating activities in continuing operations, as well as regular mortgage loan principal repayments and improvements to income properties. The remaining net cash inflow from discontinued operations is primarily designated for lump-sum debt repayments, including the retirement of convertible debenture debt. The net cash inflow from other financing and investing activities, including the net borrowing under the revolving loan from 2668921 Manitoba Ltd. and the line of credit with the Royal Bank of Canada, represents a supplemental or interim source of funds for lump-sum debt repayments.

During 2010, LREIT utilized \$2,960,000 on the line of credit and \$7,350,000 on the revolving loan and used \$2,590,366 of existing cash to fund the net cash outflow from all other operating, financing and investing activities.

## Source and Use of Funds - 2010 Summary

### Continuing Operations

An analysis of the cash flows of LREIT for 2010, separated into "continuing operations" and "discontinued operations" is provided in the chart which follows this section of the MD&A. The analysis discloses the following:

- (i) the net cash outflow from operating activities, regular mortgage principal payments and improvements to income properties was \$11,708,479.
- (ii) after including other financing and investing activities, there was a net cash outflow of \$19,476,460 from continuing operations. As disclosed in the Consolidated Statements of Cash Flows in the financial statements, the cash inflows and outflows for other financing and investing activities, include the following items:

#### *Inflows:*

- net proceeds from upward mortgage loan financing of \$2,063,351;
- gross proceeds of \$19,417,000 from the mortgage bond/warrant offerings in March 2010 and December 2010.
- net proceeds of \$10,090,650 from the collection of mortgage loans receivable;
- a net draw on the line of credit of \$2,960,000;
- a net draw on the revolving loan commitment of \$7,350,000;

#### *Outflows:*

- the repayment of \$11,950,000 of convertible debentures in March 2010;
- the repayment of \$4,000,000 of vendor take-back financing in November 2010;
- the repayment of \$4,500,000 of second mortgage loans payable debt in July 2010;
- the repayment of \$6,780,000 of mortgage bonds in the fourth quarter of 2010.
- an increase in restricted cash of \$15,314,818;
- an investment in defeasance assets of \$3,338,341; and
- expenditures on transaction costs of \$3,594,217.

### Discontinued Operations

As disclosed in the cash flow analysis, the net cash inflow from discontinued operations was \$16,886,094, comprised of the following components:

- (i) a net cash inflow of \$2,388,031 from the "operations" of discontinued properties;
- (ii) a net cash inflow from property sales of \$17,563,501. The net cash inflow from property sales is net of selling expenses and any mortgage loans payable debt which was discharged on sale or assumed by or provided to the Purchaser;
- (iii) a net cash inflow from interim mortgage loan refinancing of \$13,500,000.
- (iv) a net cash outflow of \$13,872,605 in regard to interim loans retired; and
- (v) a net cash outflow of \$2,692,833 from other financing and investing activities, including expenditures on transaction costs of \$1,436,791.

## Ending Cash Position

The net cash outflow from continuing and discontinued operations amounted to \$2,590,366 during 2010. After accounting for the opening bank balance of \$4,287,864, LREIT completed 2010 with a cash balance of \$1,697,498.

### Cash Flow Analysis (Note 1) -Year Ended December 31, 2010

#### CONTINUING OPERATIONS

|                                                                            |             |    |               |
|----------------------------------------------------------------------------|-------------|----|---------------|
| Cash provided by (used in) operating activities                            |             | \$ | (4,220,858)   |
| Cash provided by (used in) on-going financing and investment activities    |             |    |               |
| Regular repayment of principal on mortgage loans                           | (6,348,643) |    |               |
| Improvements to income properties (Note 2)                                 | (1,138,978) |    | (7,487,621)*  |
| Shortfall in cash provided by operating activities                         |             |    | (11,708,479)* |
| Cash provided by (used in) other financing and investment activities       |             |    |               |
| Total cash used in financing activities                                    | (5,554,115) |    |               |
| Total cash used in investing activities                                    | (9,701,487) |    |               |
| Add back: Financing/investing cash outflows deducted above                 | 7,487,621 * |    | (7,767,981)*  |
| Net cash outflow from continuing operations                                |             |    | (19,476,460)  |
| DISCONTINUED OPERATIONS                                                    |             |    |               |
| Cash provided by (used in) operations of properties sold and held for sale |             |    | 2,388,031     |
| Net cash proceeds from property sales                                      |             |    | 17,563,501    |
| Net proceeds of interim mortgage loan financing                            |             |    | 13,500,000    |
| Interim loans retired                                                      |             |    | (13,872,605)  |
| Cash provided by (used in) other activities in discontinued operations     |             |    | (2,692,833)   |
| Net cash inflow from discontinued operations                               |             |    | 16,886,094    |
| Cash decrease                                                              |             |    | (2,590,366)   |
| Cash, beginning of period                                                  |             |    | 4,287,864     |
| Cash, end of period                                                        |             | \$ | 1,697,498     |

#### Note 1 - GAAP Measurements

The preceding cash flow analysis represents the re-formatting of amounts from the Consolidated Statement of Cash Flows in the financial statements in order to separately identify the variance between the cash inflow from operating activities and the cash outflow from "ongoing" financing and investing activities and to highlight the cash inflows/outflows associated with property sales and lump-sum repayments of interim mortgage loans payable debt. The specific line item amounts which are disclosed in the analysis, agree to the Consolidated Statement of Cash Flows with the exception of the asterisked sub-totals and the line amount titled "cash provided by (used in) other activities in discontinued operations" which is the cumulative total of the individual amounts which are not separately disclosed in the analysis. The order of presentation of the line items differs from the Consolidated Statement of Cash Flows, as follows:

- the cash outflows for two financing activities (regular repayments of principal on mortgage loans and distributions) and one investing activity (improvements to income properties) are disclosed separately under the category of "Ongoing Financing and Investing Activities".
- the net cash outflow for the remaining financing and investment activities are disclosed under the category of "Other Financing and Investing" activities.

#### Note 2 - Improvements to Income Properties

Improvements to income properties consist of capital expenditures which were incurred during the normal course of operations, such as improvements to the income properties and grounds, as well as, common area upgrades and in-suite replacements, including appliances, carpeting and draperies.



## Sources and Use of Funds - 2011

### Sources

#### Existing Cash/Working Capital Deficiency

As of December 31, 2010, the unrestricted cash balance of LREIT was \$1,697,498.

As of December 31, 2010, the working capital deficit of LREIT was \$12,693,162. The working capital deficit consists of cash and other assets, excluding restricted cash, less bank indebtedness and accounts payable and accrued liabilities, excluding the liability for tenant security deposits, the amount payable on acquisition of Parsons Landing and the amount payable for interest rate swaps. Including the amount payable on acquisition of Parsons Landing of \$47,720,000, the working capital deficit of LREIT was \$60.4 Million as of December 31, 2010.

The liability for tenant security deposits is excluded as cash held in escrow for tenant security deposits is included in restricted cash. Mortgage principal payments and convertible debenture payments due within the twelve month period ending December 31, 2011 are not included in the calculation of the working capital deficit.

As of December 31, 2010, the balance of restricted cash is \$20,343,338. Restricted cash includes proceeds of \$8,947,815 from the initial closing of the mortgage bond/warrant offering in December 2010 which were being held in escrow, as of December 31, 2010, for the purpose of funding the repayment of the Series F convertible debentures due March 11, 2011. Cash deposits provided to mortgage lenders as additional security or as a capital expenditure reserve fund in the total amount of \$9,511,409 are also included in restricted cash.

Working capital is a commonly used financial measurement of an entity's liquidity and is generally derived by deducting current assets from current liabilities, excluding short-term debt. Working capital is a non-GAAP measurement and the method which is used by LREIT for calculating the working capital deficit may differ from the method which is used by other issuers. Accordingly, the working capital deficit as calculated by LREIT may not be comparable to the working capital measurements which are provided by other issuers.

#### Revolving Line of Credit

The Trust utilizes a revolving line of credit from a Canadian chartered bank with an authorized limit of \$5 Million. The line of credit bears interest at the Royal Bank of Canada prime rate plus 3.5%. The amount available under the line of credit at December 31, 2010 was \$1,915,000. The amount available on the line of credit is reduced by \$125,000 securing a letter of credit. As of the date of this report, the line of credit is fully utilized.

#### Revolving Loan Commitment from 2668921 Manitoba Ltd.

LREIT utilizes a \$10 Million revolving loan commitment from 2668921 Manitoba Ltd. The loan bears interest at 14%, matures on June 30, 2011 and is secured by mortgage charges against the title to six income properties and an assignment of a mortgage loan note receivable in the amount of \$500,000. As of December 31, 2010, \$2,650,000 of the revolving loan was available to the Trust. As of the date of this report, the revolving loan is fully utilized.

The revolving loan is included in "Accounts Payable and accrued liabilities" on the consolidated Balance Sheet of LREIT. Additional information regarding the financing arrangements with 2668921 Manitoba Ltd. are provided in the section of this report titled "Related Party Transactions".

### **Cash from Operating Activities**

During 2010, the net cash outflow from operating activities in continuing operations and from the "operation" of discontinued properties was \$1,832,827. After funding regular payments of mortgage principal and property improvements in continuing and discontinued operation, the cash outflow was approximately \$11.0 Million in 2010. Operating income and interest expense are the main components of cash flow from operations, with the Fort McMurray property portfolio being the main contributor to operating income.

It is generally anticipated that rental market conditions in Fort McMurray will gradually improve during 2011 and that the property portfolio of LREIT will achieve a modest increase in operating income during 2011.

During 2011, and notwithstanding the timing differences, LREIT will effectively be replacing approximately \$13.6 Million of 7.5% convertible debenture debt and \$6.78 Million of 9% mortgage bond debt with \$16 Million of 9% mortgage bond debt, representing a net reduction in debt of \$4.38 Million. The reduction of debt was funded by the sale of Three Lake Village in November 2010. The decrease in interest expense associated with this debt reduction may be offset by an increase in financing expense for mortgage loans payable debt given the potential interest rate increases and fees associated with the mortgage loans payable debt which is in breach of debt service coverage requirements. Interest expense associated with the bank line of credit and revolving loan commitment is also expected to increase during 2011.

Overall, financing expense, on a cash basis, is not expected to change significantly in 2011. The completion of mortgage loan arrangements for Parsons Landing or the termination of the interest forgiveness allowance could also affect the level of financing expense in 2011.

In summary, although cash from operating activities is expected to improve in 2011, LREIT will continue to require other sources of cash to fund regular payments of mortgage loan principal and property improvement costs.

### **Discontinued Operations**

As of December 31, 2010, seven properties were classified as held for sale by LREIT. The estimated gross selling price and estimated net cash proceeds of the held for sale properties is \$141.0 Million and \$56.0 Million, respectively, after deducting \$3.7 Million in capital gains tax.

### **Mortgage Loans Receivable**

As of December 31, 2010, LREIT holds a \$500,000 mortgage loan receivable relating to vendor take-back financing on the sale of a property. The loan matures in 2014 and provides for payments of interest only.

### **Mortgage Loan Financing**

As opportunities arise, first mortgage loans may be upward refinanced at maturity in order to raise additional capital to supplement the cash generated from operating activities.

### **Debt and/or Equity Offerings**

LREIT may have the capability of pursuing additional offerings of debt and/or equity in the future as a source of investment capital. LREIT may also issue trust units to vendors as consideration for real property acquisitions.

The second closing of the mortgage bond offering occurred on January 28, 2011, resulting in gross proceeds of \$3,363,000 which were used, together with other funds, to repay the principal amount of the Series F Debentures on maturity.

## Uses

### Parsons Landing

As previously disclosed in this report, the deadline for payment of the balance owing for Parsons Landing of approximately \$47.7 Million was extended to June 30, 2011, subject to the completion of mortgage financing arrangements by LREIT by April 30, 2011. After providing for \$1.4 Million of furniture credits and \$12 Million of second mortgage loan financing from the vendor, the amount required to complete the purchase of the property is approximately \$29.3 Million. Based on anticipated first mortgage loan financing of \$24.3 Million, the amount payable in cash will be approximately \$5 Million.

As of the date of this report, LREIT has not obtained a commitment for the required mortgage financing for Parsons Landing.

### Mortgage Loan Principal Payments

#### *Continuing Operations*

A summary of the debt obligations of LREIT relating to continuing operations for 2011 and for the next five years, is provided in the following chart:

| <b>Summary of Contractual Obligations - Long-term Debt</b> |                       |                       |                      |                      |                        |
|------------------------------------------------------------|-----------------------|-----------------------|----------------------|----------------------|------------------------|
| <u>Payments Due by Period</u>                              | <u>Total</u>          | <u>2011</u>           | <u>2012/2013</u>     | <u>2014/2015</u>     | <u>2016 and beyond</u> |
| Regular mortgage loans                                     | \$ 98,944,462         | \$ 5,770,455          | \$ 70,184,880        | \$ 15,367,063        | \$ 7,622,064           |
| Mortgage loans with covenant breaches                      | 160,844,986           | 160,844,986           | -                    | -                    | -                      |
| Total                                                      | <u>\$ 259,789,448</u> | <u>\$ 166,617,452</u> | <u>\$ 70,186,892</u> | <u>\$ 15,369,077</u> | <u>\$ 7,622,064</u>    |

#### *Discontinued Operations*

The mortgage loans payable debt for the seven properties which are classified as "held for sale" as of December 31, 2010, amounts to \$87.1 Million, including interim mortgage loans payable. Of this amount, \$34,386,282 is considered "repayable" during 2011.

#### **Summary of mortgage loans payable debt "Due in 2011"**

As previously noted, the amount of long-term debt which is considered "due" during 2011 in accordance with GAAP, includes all mortgage loans which are payable on demand and all mortgage loans which are in default of covenant breaches, as well as the fixed term mortgages which mature during the year.



An analysis of the mortgage loans payable debt which is considered due in 2011 for continuing operations and for discontinued operations in the amount of \$166,615,441 and \$54,451,111, respectively, is provided on the following chart.

|                                                                                             | Continuing<br>Operations | Discontinued<br>Operations | Total                 |     |
|---------------------------------------------------------------------------------------------|--------------------------|----------------------------|-----------------------|-----|
| Mortgages                                                                                   |                          |                            |                       |     |
| Fixed term mortgages with covenant breaches which matured in 2010 and are payable on demand | \$ 35,926,136            | \$ -                       | \$ 35,926,136         | (1) |
| Fixed term mortgages which mature in the first quarter of 2011:                             |                          |                            |                       |     |
| -with covenant breaches                                                                     | -                        | 4,976,540                  | 4,976,540             | (1) |
| -other                                                                                      | 2,491,574                | 14,870,000                 | 17,361,574            | (2) |
| Fixed term mortgages which mature in the remainder of 2011:                                 |                          |                            |                       |     |
| -with covenant breaches                                                                     | 54,439,020               | -                          | 54,439,020            | (1) |
| -other                                                                                      | -                        | 12,835,570                 | 12,835,570            |     |
|                                                                                             | 92,856,730               | 32,682,110                 | 125,538,840           |     |
| Repayments                                                                                  | 3,278,881                | 1,704,172                  | 4,983,053             |     |
| Fixed term mortgages with covenant breaches due in 2012 and subsequent                      | 70,479,830               | 20,064,829                 | 90,544,659            | (1) |
|                                                                                             | <u>\$ 166,615,441</u>    | <u>\$ 54,451,111</u>       | <u>\$ 221,066,552</u> |     |

(1) An analysis of mortgage loans which are in breach of debt service coverage requirements is provided in the "Mortgage Loans Payable" section of the MD&A.

(2) The status of the fixed term mortgage loans which mature in the first quarter of 2011 is provided in the "Mortgage Loans Payable" section of the MD&A.

## Investing Activities

Property improvement costs to December 31, 2010 were \$1,138,978. For 2011, property improvement costs are not expected to exceed \$1.6 Million.

## Reserves Required by Mortgage Loan Agreements

In accordance with mortgage loan agreements, cash deposits are provided to certain lenders to fund future capital repairs and/or as additional security under the loan agreements. During 2010, cash deposits of \$8,211,686 were deposited with lenders, of which \$7,926,000 pertains to mortgage loans which are in breach of debt service coverage requirements.

Additional cash deposits may be required during 2011.

## Convertible Debenture/Principal Payments

A summary of the net amount outstanding as of December 31, 2010 in regard to the two series of convertible debentures is provided in the following chart.

| Issue Date/Maturity Date | Series | Amount Issued        | Net Amount Outstanding<br>December 31, 2010 |
|--------------------------|--------|----------------------|---------------------------------------------|
| Mar. 10/06/Mar. 11/11    | F      | \$ 13,680,000        | \$ 13,601,000                               |
| Dec. 8/06/Dec. 31/11     | G      | <u>25,732,000</u>    | <u>25,595,000</u>                           |
| Face value               |        | <u>\$ 39,412,000</u> | <u>\$ 39,196,000</u>                        |

The Series F debentures were fully repaid on March 11, 2011. Funding sources for the repayment included the proceeds from the December 2010 mortgage bond/warrant offering.

In accordance with the terms of the trust indenture for the Series G debentures, the Trust has the option at the maturity of the Series G debentures to retire the debentures, in whole or in part, by issuing Trust units. The number of units issued at redemption is determined by dividing the principal of debentures redeemed by 95% of the current market price of the trust units.

## RELATED PARTY TRANSACTIONS

### **Shelter Canadian Properties Limited ("Shelter Canadian")**

#### *Asset and Property Management*

Shelter Canadian provides administrative and asset management services to LREIT, pursuant to the terms of a Services Agreement expiring on December 31, 2015. The Services Agreement provides for the remuneration of Shelter Canadian to be established at a level which is commensurate with customary comparable market asset management fees, subject to the discretion of the Governance, Compensation and Nominating Committee of the Board of Trustees.

Shelter Canadian currently receives a service fee equal to 0.3% of the gross book value of the total assets of the Trust. The gross book value of the total assets of the Trust is defined as the total assets, as disclosed on the most recently issued financial statements, excluding cash and forbearance assets. Payment of the fee occurs on a monthly basis, on the last day of each month. The current term of the Services Agreement expires on December 31, 2015. During 2010, LREIT incurred service fees payable to Shelter Canadian of \$1,752,587. Service fees are included in trust expense.

Shelter Canadian is also the Property Manager for LREIT, pursuant to the Property Management Agreement expiring on December 31, 2015. Shelter Canadian has a direct involvement in the management of all of the income properties in the portfolio of LREIT and acts as the Property Manager for all of the properties, except for the seniors housing complexes, which are managed by third party managers who specialize in seniors housing and Siena Apartments, which is managed by a third party manager. In accordance with the terms of the Property Management Agreement, Shelter Canadian receives a property management fee equal to 4% of gross receipts from the income properties which it manages. In regard to commercial properties, Shelter Canadian Properties Limited is also entitled to leasing commissions on new leases of 3% to 5% of base rental payments and leasing commissions on renewal of 1 1/2% to 2 1/2% of base rental payments. Shelter Canadian Properties Limited is also entitled to tenant improvement and renovation fees equal to 5% of the total cost of such work. The current term of the Property Management Agreement expires on December 31, 2015.

Property management fees are included in property operating costs. Leasing commissions and tenant improvement and renovation fees are capitalized to income properties. During the period of major in-suite renovations or development operating costs are capitalized to the cost of buildings and properties under development.

During 2010, LREIT incurred property management fees on continuing operations payable to Shelter Canadian of \$1,248,936. LREIT did not incur any leasing commissions for continuing operations during 2010. LREIT did not incur any tenant improvement and renovation fees for continuing or discontinued operations during 2010.

During 2010, LREIT incurred property management fees on discontinued operations payable to Shelter Canadian of \$1,040,109, as well as leasing commissions of \$60,555.

### *Loans*

During 2009, LREIT obtained a 7.5% \$500,000 second mortgage loan and a \$5 Million revolving "operating" loan commitment from 2668921 Manitoba Ltd., the parent company of Shelter Canadian. The second mortgage loan matured on January 1, 2011 and has been extended to June 30, 2011.

In November 2010, the amount of the revolving loan commitment was increased to \$10 Million, the expiry date was extended from December 31, 2010 to June 30, 2011 and the interest rate was increased from 7.5% to 14%. The extension of the maturity date and the increase in the loan amount encompassed a refinancing fee of \$50,000 representing 0.5% of the increased loan amount. The revolving loan is secured by mortgage charges against the title to six income properties and an assignment of a mortgage loan note receivable in the amount of \$500,000.

The terms of the loans and the granting of security were approved by the independent Trustees. Mr. Arni Thorsteinson, the Chief Executive Officer of LREIT and a Trustee, is also President of Shelter Canadian Properties Limited and President of 2668921 Manitoba Ltd. and abstained from voting in regard to all matters concerning the loans.

## **REVENUE/INCOME AND OTHER COMMITMENTS**

### **Lakewood Manor**

All of the units at Lakewood Manor were leased by a major oil sands company, pursuant to a three year lease agreement, under which the lessee was also responsible for all property operating costs. The lease agreement with the oil sands company expired on May 31, 2010 and was not renewed. The rental revenue for Lakewood Manor was reduced by the provision for a \$1 Million rental abatement in the second quarter of 2010 comprised of a \$325,000 rent adjustment and a \$675,000 credit against future rental accommodations by the tenant through 2013.

The expiry of the lease agreement for the entire property also resulted in an above average vacancy loss for Lakewood Manor subsequent to May 31, 2010, given the time required to lease individual units at the property in a competitive rental market.

### **Siena Apartments**

The acquisition of Siena Apartments was completed by LREIT, effective July 2, 2008. All of the units at the property are leased by a major oil sands company, pursuant to a lease agreement expiring May 1, 2012, under which the lessee is also responsible for all property operating costs. The net operating income of the property is approximately \$2.2 Million per annum, representing the amount of net rental revenue.

The agreement also provides the oil sands company with an option to extend the lease for an additional five years at current market rates at that time.

LREIT also has a right of first refusal to acquire Cortona Apartments (formerly known as Phase II of Siena Apartments). Cortona Apartments consists of 57 suites and is also 100% leased to the same major oil sands operating company on a net rent basis for a five-year term until 2013.

### **Elgin Lodge**

In conjunction with the acquisition of Elgin Lodge in June 2006, LREIT retained Kingsway Arms Management Services Inc. ("Kingsway") to manage the property for a ten year term, expiring on May 31, 2016. Kingsway is an Ontario-based company, which acquires, manages and develops retirement homes, catering principally to the independent and assisted living segments. Kingsway currently manages a portfolio of nine properties, totaling 850 suites located across Ontario.



A 60-suite expansion was completed at Elgin Lodge during 2007. During the five year period from June 1, 2006, Kingsway is entitled to a one-time payment equal to 50% of the amount by which the appraised value of the expanded property exceeds the total of the cost of the property to LREIT, including the cost of the expansion and the unpaid portion of a 12% annual return on the LREIT equity investment. Consideration recorded at December 31, 2010, of \$434,982 is included in the liabilities of properties held for sale, as accounts payable and accrued liabilities.

### **The Clarington Seniors Residence**

LREIT has also retained Kingsway to manage The Clarington Seniors Residence for a ten-year term, expiring on February 12, 2017. During the five year period after the "lease-up" date, Kingsway is entitled to a one-time payment equal to 50% of the amount by which the appraised value of the property exceeds the total of the original acquisition cost to LREIT and the unpaid portion of a 8% annual return on the LREIT equity investment. Consideration recorded at December 31, 2010, of \$477,901 is included in the liabilities of properties held for sale, as accounts payable and accrued liabilities.

## **CHANGES IN ACCOUNTING POLICIES**

### **Future Changes to Significant Accounting Policies**

#### **International Financial Reporting Standards ("IFRS")**

##### **Reason for Change to IFRS**

Effective January 1, 2011, the accounting framework under which all publicly accountable enterprises in Canada are required to prepare financial statements, as established by the Canadian Accounting Standards Board, officially changed from "Generally accepted accounting principles" ("GAAP") to "International Financial Reporting Standards" ("IFRS").

Accordingly, LREIT adopted International Financial Reporting Standards effective January 1, 2011.

##### **IFRS Changeover Activities**

LREIT has undertaken a number of activities in regard to identifying differences between GAAP and IFRS, evaluating alternative methods of adoption of specific IFRS accounting policies, assessing the expected effects of IFRS on the financial statements of the Trust and identifying the impact of the changeover to IFRS on the business activities of Trust, including the impact on the control system, IT systems and training requirements of the Trust.

A summary of the key activities related to the IFRS changeover, including the timing and status of each key activity, is provided in the following chart. More detailed information in regard to the specific accounting standards that are to be adopted by the Trust under IFRS is provided in the section of the MD&A which follows the chart.

| Key Activity                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             | Timing                                                                                                                                                                                                                                                                                                                                                                                                                                             | Status                                                                                                                                   |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Financial Statement Preparation</b> <ul style="list-style-type: none"> <li>Identify changes in accounting policy between GAAP and IFRS</li> <li>Evaluate and select accounting method for accounting policies that encompass options</li> <li>Identify differences in recognition, measurement and financial statement disclosure under IFRS</li> <li>Prepare financial statements for 2010 IFRS comparatives</li> </ul>                                                                                                                                                                                                                                              | <ul style="list-style-type: none"> <li>Selection and approval of new accounting policies by August 31, 2010</li> <li>Completion of IFRS financial statement template and Q1 2010 comparatives by September 8, 2010</li> <li>Completion of IFRS Q2 2010 comparatives by November 30, 2010</li> <li>Completion of IFRS Q3 2010 comparatives by December 15, 2010</li> <li>Completion of IFRS 2010 year end comparatives by April 15, 2011</li> </ul> | <ul style="list-style-type: none"> <li>Completed</li> <li>Completed</li> <li>Completed</li> <li>Completed</li> <li>In process</li> </ul> |
| <b>Training</b> <ul style="list-style-type: none"> <li>Provide comprehensive technical training to senior staff members in the accounting and investor reporting departments</li> <li>Provide specific job-related training to other accounting staff members following the identification of new accounting policies and methods</li> <li>Communicate impact of IFRS to trustees</li> </ul>                                                                                                                                                                                                                                                                             | <ul style="list-style-type: none"> <li>In-house seminars conducted in December 2008 and December 2009</li> <li>On-going, as needed</li> <li>On-going, with more specific information provided over time. Focus to be on updates to Audit Committee at quarterly meetings</li> </ul>                                                                                                                                                                | <ul style="list-style-type: none"> <li>Completed</li> <li>Proceeding, as planned</li> <li>Proceeding, as planned</li> </ul>              |
| <b>Business Impacts</b> <ul style="list-style-type: none"> <li>Determine impact of IFRS financial statement presentation and disclosure on MD&amp;A</li> <li>Identify impact of IFRS on business activities, including asset and property management fee structures and debt covenants</li> </ul>                                                                                                                                                                                                                                                                                                                                                                        | <ul style="list-style-type: none"> <li>Completion of IFRS template for MD&amp;A by December 31, 2010</li> <li>Assessment and recommendations in respect of major issues to be completed by December 31, 2010</li> </ul>                                                                                                                                                                                                                            | <ul style="list-style-type: none"> <li>Substantially completed</li> <li>Completed</li> </ul>                                             |
| <b>IT Systems</b> <ul style="list-style-type: none"> <li>Implement changes to general ledger and financial statement accounting systems</li> <li>Identify and implement any other changes required to the IT system</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                           | <ul style="list-style-type: none"> <li>No changes to general ledger and financial statement accounting systems</li> <li>No changes required to the IT system</li> </ul>                                                                                                                                                                                                                                                                            | <ul style="list-style-type: none"> <li>Completed</li> <li>Completed</li> </ul>                                                           |
| <b>Control Environment</b> <ul style="list-style-type: none"> <li>Identify impact of IFRS on internal controls and disclosure controls and procedures</li> <li>Implement changes to control systems, as required</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                              | <ul style="list-style-type: none"> <li>On-going</li> <li>All incremental controls to be implemented by January 1, 2011</li> </ul>                                                                                                                                                                                                                                                                                                                  | <ul style="list-style-type: none"> <li>Proceeding, as planned</li> <li>Completed</li> </ul>                                              |
| <b>Other</b> <ul style="list-style-type: none"> <li>Classification of trust units: During the initial review of accounting policies under IFRS, it was determined that the units of LREIT could potentially be regarded as a liability rather than equity, with the associated distributions classified as interest expense, as a result of the mandatory distribution requirements which were established in the Declaration of Trust. In order to continue to present units as equity, the Unitholders approved an amendment to the Declaration of Trust in December 2009 to provide for distributions to be established at the discretion of the Trustees.</li> </ul> |                                                                                                                                                                                                                                                                                                                                                                                                                                                    |                                                                                                                                          |

## **Description of New Accounting Standards**

### ***IFRS 1 - First-time adoption of International Financial Reporting Standards***

The adoption of IFRS requires the application of IFRS 1, "First-Time Adoption of International Financial Reporting Standards". IFRS 1 provides guidance for an entity's initial adoption of IFRS and provides for certain exceptions and limited optional exemptions in specified areas of certain standards. IFRS 1 generally requires that an entity apply all IFRS effective at the end of its first IFRS reporting period, retrospectively, with all adjustments to assets and liabilities taken to retained earnings unless certain exemptions are applied. The Trust does not expect to apply any exemptions in the transition to IFRS.

IFRS 1 requires that comparative information for 2010 be restated to reflect the application of IFRS. The retrospective application of IFRS will encompass the restatement of the opening balance of assets, liabilities and equity as of January 1, 2010 and the presentation of the January 1, 2010 opening balance sheet for financial statements prepared as of March 31, 2011, June 30, 2011, September 30, 2011 and December 31, 2011.

### ***IAS 40 - Investment properties***

Income properties as reflected in the December 31, 2010 financial statements will be considered to be "Investment Properties" and the accounting principles enumerated under IAS 40 "Investment Property" (IAS 40) will apply. This will include income properties which are disclosed in discontinued operations, with the exception of the four seniors housing complexes.

As with GAAP, IAS 40 requires that investment properties initially be measured at cost. Subsequent to initial recognition, IAS 40 provides an entity with two choices, as follows:

- cost method: continue with a cost valuation model with note disclosure of fair values
- fair value method: recognize the fair value of investment properties on the balance sheet with changes in fair value recognized in income.

The Trust has selected the fair value method of presenting investment properties in the financial statements.

The fair value of investment properties will be determined using the "valuation process" of the Trust. The valuation process will encompass the use of appraisal reports from independent third party appraisers, as well as internal estimates of value based on capitalization and discount rates provided by external valuers. The fair value of "held for sale" investment properties which are under contract for sale will be based on the contractual sales price, less estimated selling costs.

A discussion of the valuation process utilized by the Trust is provided below.

### ***IAS 16 - Property, plant and equipment***

As the four seniors housing complexes have a significant operating component in the form of delivery of services to residents, the four seniors housing complexes of LREIT will be classified as "Property, plant and equipment", in accordance with IFRS 16.

Under IAS 16, "Property, plant and equipment" is measured at cost, less accumulated amortization and any accumulated impairment losses. Amortization is not recorded for property, plant and equipment which is classified as discontinued operations. As, the four seniors housing complexes of LREIT will be classified as discontinued operations, amortization charges will not be recorded for the properties.



IFRS 1, First Time Adoption of Financial Reporting Standards provides an entity with the option on the initial transition to IFRS to record a "one-time" valuation adjustment for property, plant and equipment whereby the carrying value or "cost" of property, plant and equipment is adjusted to reflect "fair market value". LREIT intends to record the "one-time" valuation adjustment for property, plant and equipment. The result of the valuation adjustment will be reflected in the January 1, 2010 opening balance sheet.

### ***IFRS 5 - Non current assets held for sale and discontinued operations***

#### ***Discontinued operations***

Under IAS 5, if a "component of a business", comprised of "a line of business" or "business in a geographic area", is held for sale, the component is to be treated as "discontinued operations" and disclosed as a current asset. As LREIT is actively pursuing a sale of all the seniors housing complexes as part of the process to become a "Qualifying REIT" under the Income Tax Act, all of the assets and liabilities of the four seniors housing complexes, including "property, plant equipment" will be classified under discontinued operations in accordance with IFRS 5 and disclosed as current assets or current liabilities in the "held for sale" classification.

#### ***Held for sale investment properties***

In accordance with IAS 5, any investment property in the LREIT portfolio which is under an unconditional sale agreement will also classified as a "held for sale" asset under current assets.

### ***Standing Interpretations Committee Interpretation 15 (SIC 15) - Operating Lease Incentives'***

SIC 15 requires that lease incentives be reflected as a reduction to rental income over the lease term on a straight-line basis. Under GAAP, lease incentives are amortized over the lease term and reflected as a charge to amortization expense. In general terms, the adoption of SIC 15 results in a reduction in rental income and a corresponding reduction in amortization expense.

As lease incentives are primarily provided in commercial properties and given that rental income from the commercial properties of LREIT represents less than 1% of the total rental income of the Trust, the adoption of SIC 15 is not expected to have a significant impact on the financial statements of LREIT.

### ***Impact of New Accounting Standards***

#### ***On-going***

#### ***Measurement of investment properties at fair value***

Income properties as reflected in the December 31, 2010 financial statements are measured at amortized cost, in accordance with GAAP.

The adoption of the fair value measurement method for investment properties under IAS 40 will result in the elimination of amortization expense and, as noted above, changes in fair value will be recognized in income. The elimination of amortization expense and the recognition of gains in fair value will result in the income of the Trust being higher than it would otherwise have been under GAAP, excluding income derived from the sale of investment properties. Income derived from the sale of investment properties will be significantly lower than it would otherwise have been under GAAP.

As noted in the discussion below on valuation processes, disclosure of investment properties at fair value will also result in a higher carrying value for income properties on the balance sheet of the Trust, in comparison to the carrying values which are disclosed under GAAP.

### *Discontinued operations*

Under GAAP, the revenue and expenses of all "held for sale" properties are included in discontinued operations. Under IFRS, discontinued operations will only reflect the revenues and expenses of the four seniors housing complexes.

As noted in the discussion below on valuation processes, the "one-time" valuation adjustment for the four seniors housing complexes will also result in a higher carrying value for seniors housing complexes on the balance sheet of the Trust, in comparison to the carrying values which were disclosed under GAAP.

The valuation adjustment for the seniors housing complexes at January 1, 2010 is based on external appraisals which were obtained in late 2009.

### *Prior Year Comparatives*

The Trust will be required to disclose fair values of its investment properties, as at January 1, 2010, in the opening balance sheet to be prepared under IAS 1 "Presentation of Financial Statements" (IAS 1) on the adoption of IFRS for the fiscal year beginning January 1, 2011.

The carrying value of the investment properties as at January 1, 2010 will reflect the initial acquisition cost, adjusted to fair value as at January 1, 2010. The fair value adjustment will be offset by an increase to the balance of retained earnings, as at January 1, 2010. The fair value as at January 1, 2010 will be based on the valuation process of the Trust.

The restatement of the carrying value of investment properties at fair value, as at January 1, 2010, and for the purpose of deriving 2010 comparatives for the 2011 IFRS financial statements, will result in the elimination of amortization expense and the gain on sale for properties which are sold in 2010. Overall, income as restated in the 2010 comparative financial statements will be substantially less than the income as originally reported under GAAP, as the gain on property sales in 2010 is \$12,673,702, while amortization expense on income properties is \$8,513,147.

### *Statement of cash flows*

The adoption of IFRS will result in a change in the "restricted", "unrestricted" and "held for sale" components of cash; however, the total amount of cash flow will be the same under IFRS and GAAP.

The adoption of IFRS will also result in a change in the amounts disclosed in each of the three cash flow categories (i.e., "operating activities", investing activities" and "financing activities") The most significant change will pertain to the disclosure of interest expense as a cash outflow from financing activities, compared to a cash outflow from operating activities under GAAP, and the disclosure of net sale proceeds as a cash inflow from investing activities, compared to a cash inflow from discontinued operations under GAAP.

### *Business Impact*

The adoption of the fair value measurement method for investment properties will result in a change in the gross book value of the total assets of the Trust. As the service fee of Shelter Canadian Properties Limited is based on the gross book value of the total assets of the Trust, the basis for determining the service fee, as stated in the Services Agreement, has been revised to ensure the amount of the fee remains unchanged.

The extent to which the adoption of the fair value measurement method for investment properties impacts other aspects of the business of the Trust will be disclosed as the review process progresses.

## Valuation Process

The Trust has created an internal valuation process to conduct ongoing valuations of its investment properties.

In this regard, investment properties have been valued using the following methods and key assumptions:

- (i) The capitalized net operating income method. Under this method, capitalization rates are applied to net operating income (revenues less property operating expenses). The key assumption is the capitalization rate reports from external knowledgeable property valuers. The capitalization rate reports provide a range of rates for various geographic regions and for various types and qualities of properties within each region.

The table below provides details of the range of capitalization rates used for valuing the investment properties of the Trust:

|                           | Range  |        |
|---------------------------|--------|--------|
|                           | Low    | High   |
| Residential properties    |        |        |
| Fort McMurray             | 7.50 % | 8.00 % |
| Yellowknife               | 6.75 % | 9.75 % |
| Other - primary markets   | 5.00 % | 7.50 % |
| Other - secondary markets | 6.25 % | 9.00 % |
| Commercial properties     | 7.00 % | 9.25 % |

- (ii) The discounted cash flow method. Under this method, discount rates are applied to the forecasted cash flows reflecting the initial terms of the leases for that specific property and assumptions as to renewal and new leasing activity. The key assumption is the discount rate applied over the useful life of the investment property.
- (iii) Direct comparison. For properties with condominium title, comparisons to the sale price of similar condominium units establishes gross sales proceeds from which the cost of completing a condominium conversion and sales program are deducted to achieve a property value. The key assumption is the cost of the condominium conversion and sales program.
- (iv) External appraisals. Independent valuations on all investment properties are carried out in accordance with a set valuation timetable as reflected in the following schedule to ensure that the carrying amount of each Investment Property does not differ materially from its fair value:

| <u>Property Value</u>      | <u>Number of Properties</u> | <u>Aggregate Value at December 31, 2010</u> | <u>Valuation Update Timetable</u> |
|----------------------------|-----------------------------|---------------------------------------------|-----------------------------------|
| Greater than \$7.5 Million | 11                          | \$ 380,000,000                              | Three years                       |
| Less than \$7.5 Million    | 12                          | 59,300,000                                  | Five years                        |
|                            | <u>23</u>                   | <u>\$ 439,300,000</u>                       |                                   |

The Trust utilizes capitalization and discount rates within the ranges provided by external valuers. To the extent that the externally provided capitalization rate ranges change from one reporting period to the next; or should another rate within the provided ranges be considered by the Trust to be more appropriate than the rate previously used, the fair value of the Investment Properties would increase or decrease accordingly.



To assist in the determination of fair value at January 1, 2010, external appraisals were obtained in 2010 for nine properties having an aggregate fair value of \$244.4 Million representing 56% of the total value of investment properties. All other properties were subject to internal valuations.

Appraisals were also obtained in 2009 for three properties having an aggregate fair value of \$60.6 Million representing 14% of the total value of investment properties.

- (v) Property sales. The sale of properties in the divestiture program provides valuable information on market conditions. Projects which are subject to an unconditional sale agreement are valued at the sale price less estimated selling expenses.

The result of the valuation process is reflected in the following table:

| IFRS/GAAP disclosure         | January 1, 2010                  |                                  | December 31, 2010                |                                  |
|------------------------------|----------------------------------|----------------------------------|----------------------------------|----------------------------------|
|                              | Fair value presentation for IFRS | Cost value presentation for GAAP | Fair value presentation for IFRS | Cost value presentation for GAAP |
| Investment/Income properties | \$ 440,300,000                   | \$ 412,232,587                   | \$ 439,300,000                   | \$ 404,346,678                   |
| Held for sale                | 116,100,000                      | 104,226,747                      | 78,135,000                       | 76,829,392                       |
| Total                        | <u>\$ 556,400,000</u>            | <u>\$ 516,459,334</u>            | <u>\$ 517,435,000</u>            | <u>\$ 481,176,070</u>            |

Investment properties and held for sale properties in the above table reflect classifications under IFRS, whereby held for sale properties include the four seniors housing complexes and properties sold in 2010.

The valuation process described above is reviewed by the auditors in the audit process.

## OPERATING RISKS AND UNCERTAINTIES

An investment in units of LREIT encompasses the risks which are inherent in the ownership and operation of a portfolio of residential and commercial properties, as well as the normal risks which are associated with an investment in a real estate investment trust. For a summary of certain additional key risks relating to LREIT, see the Annual Information Form, which is available at [www.sedar.com](http://www.sedar.com).

The key risks include the following:

### Continuing Operations

As previously disclosed in this report, there are a number of variables and risk factors that have been identified in regard to the assessing whether LREIT has the ability to continue to operate, including: (i) the net losses sustained by LREIT in 2010 and prior years, (ii) the breach of net operating income achievement and debt service coverage requirements on six mortgage loans (relating to eleven properties) encompassing \$160.8 Million of mortgage loans payable debt, (iii) the impact of the continuation of high vacancy rates and reduced rental rates in Fort McMurray on the ability of LREIT to continue to secure financing on the Fort McMurray properties, and (iv) the working capital deficit of the Trust, as of December 31, 2010 in the amount of \$12,693,162.

As a result of the steps which have been taken to address the risk factors, and after considering events which have occurred during 2010 and into 2011, including the repayment of the Series E debentures in February 2010; the repayment of the Series F debentures on March 11, 2011; the completion of two public offerings of mortgage bonds; the renewal or refinancing of mortgage loans and/or positive ongoing discussions with lenders for mortgages which have matured to the date of this report; and the completion of 18 property sales in 2009 and 2010, management believes that LREIT has the financial capacity to continue operations in 2011.

The main variable which will affect the financial capacity of LREIT to continue operations in 2011 is the timing and extent of property sales and upward refinancing. In the event that the net proceeds from property sales or upward refinancing are less than anticipated, LREIT may not have the ability to fund operating losses or debt obligations, including regular monthly payments of mortgage loan principal.

### **Real Property Ownership**

The properties of LREIT are subject to the normal risks common to real property ownership and operation, including the risk of a reduced demand due to changes in general economic conditions, local real estate markets, competition from other available premises and various other factors.

The properties of LREIT generate income through rent payments made by the tenants of the properties. Upon the expiry of any lease, there can be no assurance that the lease will be renewed or the tenant replaced. The terms of any subsequent lease may be less favourable than the existing lease. Leasing results are affected by a number of factors, including location of the property and, in particular, the level of supply and demand in the local rental market.

### **Public Market Risk**

It is not possible to predict the price at which units will trade in the future and there can be no assurance that an active trading market for the units will be sustained. The units will not necessarily trade at values determined solely by reference to the value of the properties of LREIT. Accordingly, the units may trade at a premium or a discount to the value implied by the value of the properties of LREIT. The market price for the units may be affected by changes in general market conditions, fluctuations in the markets for equity securities and numerous other factors beyond the control of LREIT.

### **Completion of Divestiture Program**

In 2009, LREIT initiated a divestiture program targeting the sale of assets, with a value in excess of \$250 Million. The objective of the divestiture program is to reduce total debt, including convertible debenture debt, and in particular higher cost interim mortgage loan financing.

During 2009, LREIT sold 13 properties under the divestiture program at a combined gross selling price of \$90.4 Million. During 2010, LREIT sold five additional properties at a combined gross selling price of \$40.4 Million. The financial statements at December 31, 2010 classify seven properties as held for sale in discontinued operations with appraised values of \$120.5 Million.

There can be no assurance that LREIT will complete the remainder of the divestiture program under the time frame or that the program will achieve the stated goals.

### **Completion of Parsons Landing Acquisition**

There is a risk that financing arrangements for Parsons Landing will not be completed within a satisfactory time frame and the property may be listed for sale by the vendor in 2011. Interest charges in the amount of \$6,910,317 as at December 31, 2010 which have been recorded as forgiven, could also become payable. See "Parsons Landing Financing".

### **Concentration of LREIT's Portfolio in One Market**

The property portfolio of LREIT has significant exposure to the Fort McMurray, Alberta market. The completion of property sales is also serving to increase the exposure of LREIT's portfolio to the Fort McMurray market.

Excluding the seven properties which are classified as "held for sale", there were 19 properties in the real estate portfolio of LREIT as of December 31, 2010, including one commercial property and 18 residential properties, comprising 1,590 rental units. The residential property portfolio includes 13 properties that are located in Fort McMurray, comprising a total of 1,167 suites, or 73% of the total residential suites in the income-producing property portfolio. The 13 properties have an aggregate acquisition price of \$336.8 Million, which represents approximately 89% of the total aggregate purchase price of the portfolio of income-producing properties.

The 13 properties in Fort McMurray accounted for 75% of the total revenue of LREIT during 2010 and 74% of the net operating income.

None of the properties which are classified as "held for sale" as of December 31, 2010 are located in Fort McMurray.

### **Oil Sands Industry**

As disclosed above, LREIT has a high concentration of properties in the Fort McMurray, Alberta market and employees from the oil sands industry represent the primary tenant base of the Fort McMurray portfolio. As previously disclosed, all of the units at the Siena Apartments are 100% leased under a lease agreement, expiring on May 1, 2012, with the option of an extension for five years at current market rates at that time.

As a result of current reduced construction activity in the oil sands industry, there is an increased risk that leases will not be renewed for suites which are leased to oil sands companies or to the employees of oil sands companies. As previously disclosed the lease agreement for Lakewood Manor was not renewed on the expiry date of May 31, 2010.

Certain significant expenditures, including property taxes, utility payments, maintenance costs, mortgage payments, insurance costs and related charges must be made throughout the period of ownership of real property regardless of whether the property is producing any income. If LREIT were unable to meet mortgage payments on any property, losses could be sustained as a result of the mortgagee's exercise of its rights of foreclosure or sale.

Real property investments tend to be relatively illiquid, with the degree of liquidity generally fluctuating in relation to demand or the perceived desirability of such investments. Such illiquidity may tend to limit LREIT's ability to vary its portfolio promptly in response to changing economic or investment conditions. If LREIT were to be required to liquidate its real property investments, the proceeds to LREIT might be significantly less than the aggregate carrying value of its properties.

### **Financing**

#### *General*

The ability of LREIT to raise additional capital for operating or investing activities is subject to uncertainty. Factors which could impair the ability of LREIT to raise additional capital include a continued downturn in general economic conditions, a more restrictive capital market, a change in legislation and numerous other factors beyond the control of LREIT.

The adoption of more restrictive and conservative lending policies by mortgage lenders following the economic downturn in October 2008, combined with the utilization of interim sources of mortgage financing by LREIT and the decline in operating income of the Fort McMurray property portfolio, has increased the level of risk for LREIT in regard to debt financing.



In the event that LREIT is unable to renew its mortgage loans payable debt at maturity, or obtain replacement financing, LREIT may not be in a position to repay the debt and would be in default of its debt obligations. In such event, the lenders could potentially take action against LREIT and the indebted properties.

#### *Covenant Breaches*

As previously disclosed in this report, LREIT is in breach of net operating income achievement and debt service coverage requirements or covenants which restrict second mortgage financing in regard to seven first mortgage loans and a second mortgage loan with a total balance of \$165,821,526 as of December 31, 2010. Two of the first mortgage loans are for two "held for sale" properties in Moose Jaw and Winnipeg.

There is a risk that the lenders of the mortgage loans which are in breach of covenant requirements could demand early repayment of the loans. Management does not anticipate that any of the lenders will demand early repayment, provided that LREIT continues to be current with its scheduled payments and interest. Management expects LREIT to remain current with its scheduled payments of principal and interest.

Management believes the default for all of the mortgage loans which are in breach of covenant requirements will be waived or satisfactorily resolved through forbearance agreements or modified loan terms. The anticipated sale of the Moose Jaw and Winnipeg properties would effectively reduce the amount of the "defaulted" debt by approximately \$25 Million.

During 2010, LREIT was required to deposit \$7.9 Million with the mortgage lenders in order to increase the cash reserve requirements for four of the mortgage loans which were in breach of debt service coverage requirements. There is a risk that significant additional cash reserve deposits may be required. During 2010, LREIT incurred \$1.2 Million of fees associated with the mortgage loans which are in breach of debt service coverage requirements. Additional fees may be incurred in 2011.

#### *Mortgage Maturities*

With the exception of two mortgage loans for properties in breach of the net operating income achievement and debt service coverage requirements, all of the mortgage loans for continuing operations which matured to December 31, 2010 were renewed, refinanced or repaid/assumed by purchaser on sale. The two loans consist of the 5.5% first mortgage loan of \$18,424,309 for the Lakewood Townhouses which matured on July 18, 2010 and the 6.5% second mortgage loan of \$17,501,827 for Woodland Park and Nelson Ridge Estates which matured on October 31, 2010. The loans are repayable on demand. A forbearance agreement was obtained from the lender in regard to the covenant breaches for both the loans with the expiry date of January 31, 2011 and an extension in the forbearance to June 30, 2011 is expected to be provided by the lender.

During the first quarter of 2011, \$22.3 Million of the mortgage loans payable debt of LREIT matured for both continuing and discontinued operations. Of this amount, \$0.5 Million has been renewed and it is expected that the remaining three mortgage loans will be refinanced with similar terms and conditions.

#### *Interim and Second Mortgage Loans*

Prior to 2009, LREIT utilized second mortgage and interim mortgage loan financing as a source of funds in order to supplement the funding of distributions as well as the funding of income property improvements and unit repurchases under the normal course issuer bid. As of December 31, 2010, the second mortgage loans and interim mortgage loans of LREIT amounted to \$39.3 Million.

During 2009 and 2010, LREIT utilized a revolving loan commitment from 2668921 Manitoba Ltd. as an interim source of financing. The ability of LREIT to fund all of its financial obligations may be partially dependent on the ongoing availability of the revolving loan commitment, which matures on June 30, 2011.

### **Payment of Cash Distributions**

A return on an investment in units is not comparable to the return on an investment in a fixed-income security. The recovery of the initial investment in units is at risk and the return on an investment in units is based on many performance assumptions. The ability of LREIT to pay cash distributions is dependent upon a number of factors, including the level of operating cash flows, the amount of cash reserves, the debt covenants and obligations of the Trust, the working capital requirements of the Trust and the future capital requirements of the Trust. Cash distributions may be reduced or suspended at any time. In addition, the market value of the units may decline if LREIT is unable to provide a satisfactory return to Unitholders.

LREIT currently qualifies as a mutual fund trust for income tax purposes. In accordance with the terms of the Declaration of Trust, the distributions of LREIT are established at the discretion of the Trustees. If circumstances permit and subject to the application of the SIFT Rules discussed below, it is the intent of the Trust to distribute an amount which is not less than all of its taxable income to its Unitholders. The Declaration of Trust provides that if the Trustees determine that available cash is not sufficient to satisfy payment of distributions, the Trustees may declare that the distribution be satisfied through the issuance of additional units, followed by an immediate consolidation of units such that, subject to the Declaration of Trust, unitholders own the same number of units on a post-consolidation basis.

Due to the decline in operating cash flow during 2009, LREIT has suspended cash distributions.

### **Changes to Tax Treatment of Trusts**

On June 22, 2007, new legislation relating to, among other things, the federal income taxation of publicly traded income trusts (the "SIFT Rules") was enacted. Under the SIFT Rules, certain distributions from a "specified investment flow-through" trust (a "SIFT") will no longer be deductible in computing a SIFT's taxable income, and a SIFT will be subject to tax on such distributions at a rate that is substantially equivalent to the general tax rate applicable to a Canadian corporation. Distributions of income of a SIFT received by a Unitholder that are not deductible to the SIFT will be characterized as dividends payable to the Unitholders. Generally, distributions paid by a SIFT as a return of capital will not be subject to the tax.

The SIFT Rules do not apply to a "real estate investment trust" (a "Qualifying REIT") that meets prescribed conditions relating to the nature of its revenue and property (the "REIT Conditions"). In the opinion of management, the Trust does not currently satisfy the REIT Conditions. Accordingly, LREIT is subject to the SIFT Rules and LREIT will be subject to the tax on taxable income commencing in 2011. Prior to 2012, LREIT will consider its alternatives, including restructuring its affairs to qualify as a Qualifying REIT, however, no assurances can be given that any reorganization can or will be implemented before 2012, or that any such reorganization, if implemented, would not result in material costs or other adverse consequences to LREIT and its Unitholders.

Please refer to the Annual Information Form for a more detailed discussion of the SIFT Rules.

### **Legal Claims**

In the normal course of operations, the Trust will become subject to a variety of legal and other claims. Management and legal counsel evaluate all claims on their apparent merits, and accrue management's best estimate of the estimated costs to satisfy such claims. Although the outcome of legal and other claims are not reasonably determinable, management believes that any such outcome will not be material.

### **Relationship with Shelter Canadian Properties Limited**

The financial performance of LREIT will depend in part on the performance of Shelter Canadian in providing administrative and asset management services to the Trust, pursuant to the Services Agreement.

### **Reliance on Key Personnel**

The success of LREIT is highly dependent on the services of certain management personnel, including Arni Thorsteinson. The loss of the services of such personnel could have an adverse effect on LREIT.

### **Other**

Other risks and uncertainties are more fully explained in the other regulatory filings of LREIT, including the Annual Information Form.

## **CRITICAL ACCOUNTING ESTIMATES**

The preparation of the consolidated financial statements of LREIT, in accordance with Canadian generally accepted accounting principles (GAAP), requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. The estimates are based on historical experience and on other assumptions that are believed to be reasonable under the circumstances. Under different assumptions or conditions, the actual results may differ, potentially materially, from the estimated amounts. Many of the conditions impacting the assumptions and estimates are beyond the control of management. The estimates and assumptions are evaluated on a periodic basis.

Financial statement items which encompass estimates include the following:

- allocation of the cost of property acquisition: a portion of the acquisition cost of an income property is allocated to tenant origination costs associated with in-place leases and the cost of tenant relationships, lease origination costs above market leases and below market leases. The amount allocated to the above is based on the estimated fair market value of each variable. The allocated amounts are of significance, as the costs are amortized over a relatively short time frame (i.e., the term of the respective tenant leases) in comparison to the amount allocated to buildings and equipment;
- amortization of the building component of Income Properties: a portion of the purchase price of an income property is allocated to "building" based on the estimated value of the building on an "as if vacant" basis. Amortization expense is based on the estimated useful life of the building. The estimated useful life of the building may vary and could result in a different amount of amortization charged to income;
- amortization of property improvements: expenditures relating to improvements to income properties are capitalized to the cost of income properties and amortized for a period of five to 25 years, based on the estimated useful life of the improvements. The estimated useful life of improvements may vary and could result in a different amount of amortization charged to income;
- the classification of properties held for sale;
- interest expense on the acquisition payable: finance expense for 2010 reflects the estimate of management that excess interest of \$6,910,317 will be forgiven.



- unit-based compensation expense: unit-based compensation expense is based on the estimated fair value of the applicable options using the Black-Scholes option pricing method;
- the determination of the amount of temporary differences, the timing of reversal and the tax rate to be used in calculating future income tax assets and liabilities;
- the allocation of convertible debentures between debt and equity based on the estimated fair value of the debt using an estimated cost of borrowing; and
- the allocation of the proceeds between mortgage bonds and warrants based on the estimated fair value of the warrants.

The estimates which were used for financial statement reporting purposes, for the above noted items, are not expected to change from period to period.

## TAXATION

### Taxation of LREIT

LREIT qualifies as a mutual fund trust for income tax purposes. Subject to the SIFT Rules, LREIT is generally subject to tax in Canada under the Income Tax Act (the "Tax Act") in respect to its taxable income each year, except to the extent that such taxable income is paid or deemed to be payable to Unitholders and deducted by LREIT for tax purposes. The distributions of LREIT are established at the discretion of the Trustees. If circumstances permit and subject to the application of the SIFT Rules, it is the intent of the Trust to distribute or designate all taxable income directly earned by LREIT to the Unitholders in order that LREIT will not be subject to income tax under Part I of the Tax Act.

LREIT does not meet the REIT Conditions under the SIFT Rules to become a Qualifying REIT, and is subject to tax on taxable income commencing in 2011 at a rate that is substantively equivalent to the general tax rate applicable to a Canadian corporation. However, distributions paid as a return of capital will generally not be subject to the tax.

### Taxation of Unitholders

The Declaration of Trust generally requires LREIT to claim the maximum amount of capital cost allowance for purposes of computing its income for tax purposes. Subject to the SIFT Rules, a Unitholder is required to include, in computing income for tax purposes each year, the portion of the amount of net income and net taxable capital gains of LREIT paid or payable to the Unitholder in the year. Distributions in excess of the taxable income of LREIT for the year which are allocated to a Unitholder are not included in computing the taxable income of the Unitholder. However, the adjusted cost base of the units which are held by a Unitholder will generally be reduced by the amount of distributions not included in income.

The cash distributions which have been paid to the Unitholders since the inception of LREIT as a real estate investment trust in September 2002, have exceeded the income of LREIT, as calculated for income tax purposes. All of the distributions, which have been paid by LREIT from September 2002 to December 31, 2010, have represented a reduction in adjusted cost base of the units; with the exception of the special distributions paid by LREIT in December 2009 and December 2010. As explained more fully in the preceeding sections of this report, the special distributions were issued to reduce the taxable income of LREIT to nil.

Under the SIFT Rules, should they become applicable to LREIT as set out above, certain distributions from LREIT which would otherwise have been ordinary income will be characterized as dividends in addition to being subject to tax in LREIT at rates similar to the combined federal and provincial corporate tax rates. Distributions to Canadian resident individuals will be deemed to be "eligible dividends", qualifying for the enhanced dividend tax credit.

Upon the disposition or deemed disposition by a Unitholder of a unit, a capital gain (or a capital loss) will generally be realized to the extent that the net proceeds of disposition of the unit exceed (or are exceeded by) the adjusted cost base of the unit. Currently, only 50% of a capital gain ("taxable capital gain") must be included in computing a Unitholders' income and 50% of a capital loss (an "allowable capital loss") may be deducted against taxable capital gains.

## **INTERNAL CONTROLS OVER FINANCIAL REPORTING**

No changes were made to the design of the internal controls over financial reporting during 2010 that have materially affected, or are reasonably likely to materially affect, the effectiveness of the internal control system.

LREIT has implemented additional controls to ensure the reliability of any financial information which is materially affected as a result of the adoption of International Financial Reporting Standards. In addition, IFRS record-keeping will be implemented within the company's financial information system to enable the capturing of financial information under multiple sets of accounting principles and required changes to data collection mechanisms are being identified as each work stream progresses.

Readers are cautioned, however, that a control system can only provide reasonable, not absolute, assurance that the objectives of the control system are achieved. Due to the inherent limitations in all control systems, an evaluation of controls cannot provide absolute assurance that all control issues, including instances of fraud, if any, have been detected. Inherent limitations include the possibility that the assumptions and judgments of management could ultimately prove to be incorrect under varying conditions and circumstances; or that isolated errors could prove to have a significant impact on the reliability of information.

Additionally, controls may be circumvented by the unauthorized acts of individuals, by collusion of two or more people, or by management override. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and it is not possible to provide complete assurance that a control system will succeed in achieving its stated goals under all potential future conditions.

## **ADDITIONAL INFORMATION**

Additional information relating to LREIT, including the Annual Information Form, is available on the SEDAR website at [www.sedar.com](http://www.sedar.com). SEDAR acts as a facilitator for the electronic filing of securities information, as required by the securities regulatory agencies in Canada.

## **APPROVAL BY TRUSTEES**

The content of the 2010 Annual Report of Lanesborough Real Estate Investment Trust, including Schedule I and Schedule II, and the delivery of the report to the Unitholders has been approved by the Trustees.

# LANESBOROUGH REAL ESTATE INVESTMENT TRUST MANAGEMENT'S DISCUSSION AND ANALYSIS - 2010

## SCHEDULE I

### Real Estate Portfolio as of December 31, 2010

#### Property Portfolio - December 31, 2010

| Property                                 | Location      | Purchase Price               | Acquisition Date | Suites/<br>Leasable Area<br>- Sq. Ft. | Occupancy<br>December 31<br>2010 |
|------------------------------------------|---------------|------------------------------|------------------|---------------------------------------|----------------------------------|
| <b>INCOME PRODUCING PROPERTIES</b>       |               |                              |                  |                                       |                                  |
| <b>RESIDENTIAL</b>                       |               |                              |                  |                                       |                                  |
| <b>Manitoba</b>                          |               |                              |                  |                                       |                                  |
| Highland Tower (1)                       | Thompson      | \$ 5,700,000                 | January 2005     | 77                                    | 99 %                             |
| <b>Alberta</b>                           |               |                              |                  |                                       |                                  |
| Norglen Terrace                          | Peace River   | 2,500,000                    | October 2004     | 72                                    | 94 %                             |
| Nelson Ridge Estates                     | Fort McMurray | 40,575,000                   | April 2005       | 225                                   | 68 %                             |
| Gannet Place                             | Fort McMurray | 6,873,700                    | June 2006        | 37                                    | 78 %                             |
| Lunar Apartments                         | Fort McMurray | 4,457,100                    | June 2006        | 24                                    | 21 %                             |
| Parkland Apartments                      | Fort McMurray | 2,230,200                    | June 2006        | 12                                    | 17 %                             |
| Skyview Apartments                       | Fort McMurray | 5,385,800                    | June 2006        | 29                                    | 65 %                             |
| Snowbird Manor                           | Fort McMurray | 6,314,500                    | June 2006        | 34                                    | 18 %                             |
| Whimbrel Terrace                         | Fort McMurray | 6,873,700                    | June 2006        | 37                                    | 62 %                             |
| Laird's Landing                          | Fort McMurray | 51,350,000                   | August 2006      | 189                                   | 73 %                             |
| Woodland Park                            | Fort McMurray | 37,865,000                   | March 2007       | 107                                   | 63 %                             |
| Lakewood Manor                           | Fort McMurray | 59,900,000                   | July 2007        | 175                                   | 58 %                             |
| Millennium Village                       | Fort McMurray | 24,220,000                   | November 2007    | 72                                    | 67 %                             |
| Parsons Landing (3)                      | Fort McMurray | 60,733,000                   | September 2008   | 160                                   | 56 %                             |
| Siena Apartments                         | Fort McMurray | 30,000,000                   | July 2008        | 66                                    | 100 %                            |
| Westhaven Manor                          | Edson         | 4,050,000                    | May 2007         | 48                                    | 81 %                             |
| <b>Northwest Territories</b>             |               |                              |                  |                                       |                                  |
| Beck Court                               | Yellowknife   | 14,300,000                   | April 2004       | 120                                   | 100 %                            |
| Nova Court (4)                           | Yellowknife   | <u>15,000,000</u>            | March 2007       | <u>106</u>                            | 83 %                             |
| <b>Total - Residential</b>               |               | <b>\$ 378,328,000</b>        | Total suites     | <b><u>1,590</u></b>                   |                                  |
| <b>COMMERCIAL</b>                        |               |                              |                  |                                       |                                  |
| Purolator                                | Burlington    | <u>1,200,000</u>             | September 2003   | <u>16,117</u>                         | 100 %                            |
| <b>Total income producing properties</b> |               | <b><u>\$ 379,528,000</u></b> |                  |                                       |                                  |



**Property Portfolio - December 31, 2010**

| Property                             | Location    | Purchase Price               | Acquisition Date       | Suites/<br>Leasable Area<br>- Sq. Ft. | Occupancy<br>December 31<br>2010 |
|--------------------------------------|-------------|------------------------------|------------------------|---------------------------------------|----------------------------------|
| <b>PROPERTIES HELD FOR SALE</b>      |             |                              |                        |                                       |                                  |
| <b>RESIDENTIAL</b>                   |             |                              |                        |                                       |                                  |
| <b>Manitoba</b>                      |             |                              |                        |                                       |                                  |
| Colony Square                        | Winnipeg    | \$ 29,907,700                | October 2008           | 428                                   | 98 %                             |
| Willowdale Gardens                   | Brandon     | 4,326,000                    | January 2006           | 88                                    | 100 %                            |
| <b>Saskatchewan</b>                  |             |                              |                        |                                       |                                  |
| Chateau St. Michael's (2)            | Moose Jaw   | 7,600,000                    | June 2006              | 93                                    | 97 %                             |
| Riverside Terrace (2)                | Saskatoon   | 24,000,000                   | July 2005              | 181                                   | 96 %                             |
| <b>Ontario</b>                       |             |                              |                        |                                       |                                  |
| Elgin Lodge (2)                      | Port Elgin  | 18,122,000                   | June 2006              | 124                                   | 71 %                             |
| Clarington Seniors Residence (2)     | Bowmanville | <u>22,400,000</u>            | February 2007          | <u>118</u>                            | 76 %                             |
| <b>Total - Residential</b>           |             | <b><u>\$ 106,355,700</u></b> | Total suites           | <b><u>1,032</u></b>                   |                                  |
| <b>COMMERCIAL</b>                    |             |                              |                        |                                       |                                  |
| <b>Retail and Office</b>             |             |                              |                        |                                       |                                  |
| Colony Square                        | Winnipeg    | <u>\$ 7,931,600</u>          | October 2008           | <u>83,190</u>                         | 99 %                             |
| <b>Light Industrial</b>              |             |                              |                        |                                       |                                  |
| 156 / 204 East Lake Blvd. (5)        | Aidrie      | <u>1,600,000</u>             | June 2003              | <u>39,936</u>                         | 100 %                            |
| <b>Total - Commercial</b>            |             | <b><u>\$ 9,531,600</u></b>   | Total leasable<br>area | <b><u>123,126</u></b>                 |                                  |
| <b>Total discontinued operations</b> |             | <b><u>\$ 115,887,300</u></b> |                        |                                       |                                  |
| <b>Total real estate portfolio</b>   |             | <b><u>\$ 495,415,300</u></b> |                        |                                       |                                  |

**Notes to the Property Portfolio:**

- (1) Includes the cost of major renovations and asset additions.
- (2) Seniors housing complex.
- (3) LREIT took possession of Parsons Landing on September 1, 2008. The vendor has provided an extension to close the transaction to June 1, 2011. See "Property Acquisitions - Parsons Landing Financing" above.
- (4) Property includes 8,400 square feet of commercial space.
- (5) 100% leased to a single tenant with occupancy on October 1, 2010.

## **LANESBOROUGH REAL ESTATE INVESTMENT TRUST MANAGEMENT'S DISCUSSION AND ANALYSIS - 2010**

### **SCHEDULE II**

#### **Summary of DRIP, NCIBs, Unit Option Plan, and Deferred Unit Plan**

##### **Distribution Reinvestment Plan ("DRIP")**

The "Distribution Reinvestment Plan" provides that Unitholders may choose to have monthly cash distributions automatically reinvested in additional units, while receiving a "bonus" distribution of units equal to 4% of the reinvested amount. Participants in the DRIP may also purchase additional units on a distribution payment date. The purchase price of the units will generally be equal to the weighted average closing price of the units for the five trading days immediately preceding the relevant distribution payment date.

There have not been any units issued under the Distribution Reinvestment Plan subsequent to the first quarter of 2009 as a result of the suspension of distributions by LREIT.

The value of the DRIP units is included in the determination of the total amount of distributions declared by LREIT.

##### **Normal Course Issuer Bids**

Subject to the approval of annual renewals, LREIT has implemented a normal course issuer bid ("NCIB") for its trust units, under which it is entitled to purchase a limited number of the issued and outstanding units of the Trust, as specified by the TSX. The NCIB was renewed in January 2011 for an additional 12 month term that expires on January 12, 2012.

Since January 2009, there have not been any purchases of trust units under the NCIB. The Trust is not required to purchase any units under the normal course issuer bid.

Subject to annual renewals, LREIT also implemented a normal course issuer bid ("NCIB") for its Series F and Series G debentures under which LREIT is entitled to purchase a limited number of the issued and outstanding debentures, as specified by the TSX. Both of the normal course issuer bids commenced on January 13, 2010 and expired on January 12, 2011. The NCIB for the Series G debentures was renewed for an additional 12 month term that expires on January 12, 2012.

During the period from January 13, 2010 to December 31, 2010, the Trust purchased and cancelled \$79,000 Series F debentures, with a face value of \$79,000, at an average price of \$89.29 per \$100.00 and \$137,000 Series G debentures, with a face value of \$137,000, at an average price of \$73.47 per \$100.00. The Trust is not required to purchase any debentures under the normal course issuer bids.

Subsequent to December 31, 2010, the Trust purchased and cancelled \$44,000 Series G debentures, with a face value of \$44,000, at an average price of \$76.82 per \$100.00.

##### **Unit Options**

Pursuant to the Unit Option Plan, the Trust may grant unit purchase options to the Trustees and senior officers of LREIT and to other individuals who are employed or retained by the Trust to perform specific duties.

As of December 31, 2010, LREIT had 968,500 options outstanding of which 912,100 or 94% had vested. LREIT has not granted any options under the Unit Option Plan since January 2008.

In accordance with Canadian generally accepted accounting principles, the estimated fair value of the options is expensed over the vesting period of the options and the expense is recorded as "unit-based compensation". Unit-based compensation expense is included in trust expense in the Consolidated Statements of Loss and Comprehensive Loss. During 2010, unit-based compensation expense related to unit options amounted to \$41,521.

As unit-based compensation is a "non-cash" expense, it does not impact the operating cash flows of the Trust.

### **Deferred Unit Plan**

The Trust has adopted a deferred unit plan, under which, any trustee, officer, employee, or consultant employee of the Trust may elect to have their annual bonus, annual board retainer or board meeting fees paid in the form of deferred units. Deferred units granted to Trustees shall vest immediately. Deferred units granted to participants other than Trustees shall vest 33% on the first anniversary of grant, 33% on the second anniversary of grant, and 34% on the third anniversary of grant. In the event of any change of control (as defined in the deferred unit plan), any unvested deferred units shall vest upon the earlier of the next applicable vesting date that is immediately prior to the date on which the change of control occurs. Whenever cash distributions are paid, additional deferred units are credited to the participant based on the number of deferred units held. The deferred units credited to a participant vest immediately and are redeemable by the participant on retirement or on "termination" other than for cause. If a participant is terminated for cause, only the deferred units which have vested shall be redeemable and any unvested deferred units shall be cancelled. Additional details of the Deferred Unit Plan are disclosed in Note 15 to the 2010 financial statements of LREIT.

The Trustees have also approved a compensation package, whereby specific fees were established for the independent Trustees for serving on the Board, acting as a Committee Chair and attending meetings. During 2010, the total fees payable to independent Trustees under the compensation package amounted to \$175,000.

All of the independent Trustees elected to have a portion of their compensation for 2010 paid in the form of deferred units. The number of deferred units received is determined by dividing the amount of the compensation by the market value of the trust units, as of the date on which the compensation is payable. Based on an average market price of \$0.54, there were 248,281 deferred units granted to the independent Trustees during 2010 for total unit-based compensation expense of \$134,750.

The value of the deferred units is a unit-based compensation expense, including in "Trust expense" in the financial statements of LREIT. Unit-based compensation expense is a "non-cash" expense, which does not affect the cash flow of the Trust.

Full details regarding the DRIP, NCIB, Unit Option Plan and Deferred Unit Plan are provided in the Annual Information Form.



## MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

The consolidated financial statements and management's discussion and analysis contained in the annual report are the responsibility of the management of Lanesborough Real Estate Investment Trust. To fulfill this responsibility, management maintains systems of internal control which are designed to give reasonable assurance that transactions are authorized and properly recorded, assets are safeguarded and financial records are properly maintained to provide reliable financial information for the preparation of the consolidated financial statements and other financial information. The consolidated financial statements have been prepared in conformity with Canadian generally accepted accounting principles and, where appropriate, reflect estimates based on management's best judgment in the circumstances.

The consolidated financial statements have been reviewed and approved by the Board of Trustees and by the Audit Committee, which is comprised of independent Trustees. The Audit Committee meets regularly with management and the auditors. The auditors have full and free access to the Audit Committee.

Meyers Norris Penny LLP, the independent auditors, appointed by the Unitholders, have audited the consolidated financial statements in accordance with Canadian generally accepted auditing standards to enable them to express to the unitholders their opinion on the consolidated financial statements.

"Arni C. Thorsteinson"

Arni C. Thorsteinson  
Chief Executive Officer

March 28, 2011

"Kenneth J. Dando"

Kenneth J. Dando  
Chief Financial Officer

## Independent Auditors' Report

To the Unitholders of Lanesborough Real Estate Investment Trust:

### *Report on the Consolidated Financial Statements*

We have audited the accompanying consolidated financial statements of Lanesborough Real Estate Investment Trust and its subsidiaries which comprise the consolidated balance sheets as at December 31, 2010 and 2009, and the consolidated statements of income (loss) and comprehensive income (loss), equity, and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory notes.

### *Management's Responsibility for the Consolidated Financial Statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian Generally Accepted Accounting Principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe the audit evidence obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Lanesborough Real Estate Investment Trust and its subsidiaries as at December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in accordance with Canadian Generally Accepted Accounting Principles.

### *Emphasis of Matter*

Without qualifying our opinion, we draw attention to Note 2 in the consolidated financial statements which indicates that Lanesborough Real Estate Investment Trust incurred losses from continuing operations of \$20,461,027 during the year ended December 31, 2010 and, as of that date, has a working capital deficit of \$12,693,162 and is in breach of certain debt covenants. These conditions, along with other matters as set forth in Note 2, indicate the existence of a material uncertainty that may cast significant doubt about the Lanesborough Real Estate Investment Trust's ability to continue as a going concern.

Winnipeg, Manitoba  
March 28, 2011  
2500-201 Portage Avenue

*Mayas Naris Penny LLP*

Chartered Accountants

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

## CONSOLIDATED BALANCE SHEETS

|                                                    | December 31          |                      |
|----------------------------------------------------|----------------------|----------------------|
|                                                    | 2010                 | 2009                 |
| <b>Assets</b>                                      |                      |                      |
| Income properties (Note 4)                         | \$361,798,003        | \$369,972,965        |
| Mortgage loans receivable (Note 5)                 | 500,000              | 7,050,000            |
| Cash                                               | 1,697,498            | 4,287,864            |
| Other assets (Note 6)                              | 21,835,938           | 6,789,902            |
| Defeasance assets (Note 7)                         | 3,313,434            | -                    |
| Assets of properties held for sale (Note 8)        | 121,510,739          | 149,043,835          |
|                                                    | <u>\$510,655,612</u> | <u>\$537,144,566</u> |
| <b>Liabilities and Equity</b>                      |                      |                      |
| Mortgage loans payable (Note 9)                    | \$258,713,190        | \$271,414,070        |
| Mortgage bonds (Note 10)                           | 9,317,075            | -                    |
| Convertible debentures (Note 11)                   | 36,986,646           | 45,940,843           |
| Accounts payable and accrued liabilities (Note 12) | 66,138,326           | 60,344,987           |
| Bank indebtedness (Note 13)                        | 2,960,000            | -                    |
| Defeased liability (Note 7)                        | 2,753,342            | -                    |
| Liabilities of properties held for sale (Note 8)   | 94,047,798           | 117,904,779          |
|                                                    | 470,916,377          | 495,604,679          |
| Equity                                             | <u>39,739,235</u>    | <u>41,539,887</u>    |
|                                                    | <u>\$510,655,612</u> | <u>\$537,144,566</u> |

Approved by the Board of Trustees

"Charles Loewen"

"Cheryl Barker"

The accompanying notes are an integral part of these financial statements.



## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

## CONSOLIDATED STATEMENTS OF EQUITY

|                                                             | Year Ended December 31 |                      |
|-------------------------------------------------------------|------------------------|----------------------|
|                                                             | 2010                   | 2009                 |
| <b>Issued capital (Note 14)</b>                             |                        |                      |
| Balance, beginning of year                                  | \$ 98,966,638          | \$ 77,661,519        |
| Units issued:                                               |                        |                      |
| Payment of distributions                                    | 8,814,286              | 19,504,206           |
| Distribution reinvestment plan                              | -                      | 108,517              |
| Exchange of LP units of Village West LP                     | -                      | 2,139,702            |
| Exchange of deferred units                                  | 79,317                 | -                    |
| Issue costs                                                 | -                      | (6,502)              |
| Units purchased under normal course issuer bid              | -                      | (440,804)            |
| Balance, end of year                                        | <u>107,860,241</u>     | <u>98,966,638</u>    |
| <b>Contributed surplus</b>                                  |                        |                      |
| Balance, beginning of year                                  | 2,536,643              | 2,089,147            |
| Maturity of Series E debentures                             | 2,835,690              | -                    |
| Issue of warrants (Note 10)                                 | 4,301,984              | -                    |
| Debentures purchased under normal course issuer bid         | 56,280                 | -                    |
| Value of unit options granted (Note 15)                     | 41,521                 | 104,355              |
| Value of deferred units granted (Note 16)                   | 134,750                | 178,094              |
| Value of deferred units redeemed (Note 16)                  | (79,317)               | -                    |
| Units purchased under normal course issuer bid              | -                      | 165,047              |
| Balance, end of year                                        | <u>9,827,551</u>       | <u>2,536,643</u>     |
| <b>Equity component of convertible debentures (Note 11)</b> |                        |                      |
| Balance, beginning of year                                  | 13,104,637             | 13,104,637           |
| Debentures purchased under normal course issuer bid         | (56,280)               | -                    |
| Maturity of Series E debentures                             | (2,835,690)            | -                    |
| Balance, end of year                                        | <u>10,212,667</u>      | <u>13,104,637</u>    |
| <b>Cumulative earnings (losses)</b>                         |                        |                      |
| Balance, beginning of year                                  | (14,432,282)           | (17,929,355)         |
| Income (loss)                                               | (6,278,907)            | 3,497,073            |
| Balance, end of year                                        | <u>(20,711,189)</u>    | <u>(14,432,282)</u>  |
| <b>Cumulative distributions to unitholders</b>              |                        |                      |
| Balance, beginning of year                                  | (58,635,749)           | (37,496,464)         |
| Distributions declared                                      | (8,814,286)            | (21,139,285)         |
| Balance, end of year                                        | <u>(67,450,035)</u>    | <u>(58,635,749)</u>  |
| <b>Total equity</b>                                         | <u>\$ 39,739,235</u>   | <u>\$ 41,539,887</u> |

The accompanying notes are an integral part of these financial statements.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

## CONSOLIDATED STATEMENTS OF INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS)

|                                                              | Year Ended December 31 |                     |
|--------------------------------------------------------------|------------------------|---------------------|
|                                                              | 2010                   | 2009                |
| <b>Revenue</b>                                               |                        |                     |
| Rentals from income properties (Note 17)                     | \$ 31,385,914          | \$ 39,662,949       |
| Interest and other income                                    | <u>959,149</u>         | <u>391,722</u>      |
|                                                              | <b>32,345,063</b>      | <b>40,054,671</b>   |
| <b>Expenses</b>                                              |                        |                     |
| Property operating costs                                     | <u>12,464,247</u>      | <u>12,727,345</u>   |
| Income before the undernoted                                 | <u>19,880,816</u>      | <u>27,327,326</u>   |
| Financing expense (Note 18)                                  | 28,793,113             | 29,068,439          |
| Trust expense                                                | 3,035,583              | 2,760,536           |
| Amortization (Note 19)                                       | <u>8,513,147</u>       | <u>8,465,980</u>    |
|                                                              | <u>40,341,843</u>      | <u>40,294,955</u>   |
| Loss from continuing operations before income taxes          | (20,461,027)           | (12,967,629)        |
| Future income tax expense (Note 20)                          | <u>-</u>               | <u>2,698,804</u>    |
| Loss from continuing operations                              | (20,461,027)           | (15,666,433)        |
| Income from discontinued operations (Note 8)                 | <u>14,182,120</u>      | <u>19,163,506</u>   |
| Income (loss) and comprehensive income (loss) for the period | <u>\$ (6,278,907)</u>  | <u>\$ 3,497,073</u> |
| Income (loss) per unit (Note 21)                             |                        |                     |
| Basic and diluted                                            |                        |                     |
| Continuing operations                                        | \$ (1.120)             | \$ (0.893)          |
| Discontinued operations                                      | <u>0.776</u>           | <u>1.092</u>        |
| Total                                                        | <u>\$ (0.344)</u>      | <u>\$ 0.199</u>     |

The accompanying notes are an integral part of these financial statements.

# LANESBOROUGH REAL ESTATE INVESTMENT TRUST

## CONSOLIDATED STATEMENTS OF CASH FLOWS

|                                                                       | Year Ended December 31 |                    |
|-----------------------------------------------------------------------|------------------------|--------------------|
|                                                                       | 2010                   | 2009               |
| <b>Cash provided by (used in) operating activities</b>                |                        |                    |
| Loss from continuing operations                                       | \$ (20,461,027)        | \$ (15,666,433)    |
| Items not affecting cash                                              |                        |                    |
| Accretion of debt component of convertible debentures (Note 18)       | 2,617,912              | 2,853,290          |
| Accretion of mortgage bonds (Note 18)                                 | 2,119,923              | -                  |
| Amortization (Note 19)                                                | 11,541,388             | 9,659,959          |
| Change in fair value of interest rate swaps (Note 18)                 | (2,711,625)            | 2,293,795          |
| Unit-based compensation                                               | 176,271                | 282,449            |
| Discount on repayment of mortgage loans receivable                    | 250,000                | -                  |
| Future income tax expense (Note 20)                                   | -                      | 2,698,804          |
|                                                                       | (6,467,158)            | 2,121,864          |
| Changes in non-cash operating items                                   | 2,246,300              | 1,356,144          |
|                                                                       | (4,220,858)            | 3,478,008          |
| <b>Cash provided by (used in) financing activities</b>                |                        |                    |
| Proceeds of mortgage loan financing                                   | 5,000,000              | 5,000,000          |
| Repayment of mortgage loans on refinancing                            | (6,936,649)            | (2,100,000)        |
| Repayment of mortgage loans from proceeds of mortgage loan receivable | (4,500,000)            | -                  |
| Repayment of principal on mortgage loans                              | (6,348,643)            | (5,137,448)        |
| Proceeds of mortgage bond financing                                   | 19,417,000             | -                  |
| Repayment of mortgage bonds                                           | (6,780,000)            | -                  |
| Repayment of Series E debentures                                      | (11,950,000)           | -                  |
| Net proceeds of line of credit                                        | 2,960,000              | (3,320,000)        |
| Proceeds of revolving loan commitment                                 | 13,964,692             | 4,905,000          |
| Repayment of revolving loan commitment                                | (6,614,692)            | (4,905,000)        |
| Expenditures on transaction costs                                     | (3,594,217)            | (248,106)          |
| Debentures purchased and cancelled under normal course issuer bid     | (171,606)              | -                  |
| Units purchased and cancelled under normal course issuer bid          | -                      | (275,757)          |
| Distributions paid on units                                           | -                      | (1,530,736)        |
|                                                                       | (5,554,115)            | (7,612,047)        |
| <b>Cash provided by (used in) investing activities</b>                |                        |                    |
| Improvements to income properties                                     | (1,138,978)            | (774,391)          |
| Investment in defeasance assets                                       | (3,338,341)            | -                  |
| Proceeds of mortgage loans receivable                                 | 10,090,650             | -                  |
| Increase in restricted cash                                           | (15,314,818)           | (2,056,496)        |
| Refund of deposits                                                    | -                      | 200,000            |
|                                                                       | (9,701,487)            | (2,630,887)        |
| <b>Sub-total</b>                                                      | <b>(19,476,460)</b>    | <b>(6,764,926)</b> |

The accompanying notes are an integral part of these financial statements.



# LANESBOROUGH REAL ESTATE INVESTMENT TRUST

## CONSOLIDATED STATEMENTS OF CASH FLOWS

|                                                                               | Year Ended December 31<br>2010 | 2009                |
|-------------------------------------------------------------------------------|--------------------------------|---------------------|
| <b>Balance forward</b>                                                        | <b>(19,476,460)</b>            | <b>(6,764,926)</b>  |
| <b>Cash provided by (used in) discontinued operations</b>                     |                                |                     |
| Income (loss) from discontinued operations (Note 8)                           | 14,182,120                     | 19,163,506          |
| Gain on sale                                                                  | (12,673,702)                   | (21,063,885)        |
| Items not affecting cash                                                      |                                |                     |
| Straight-line rent adjustment                                                 | 164,736                        | (9,684)             |
| Amortization                                                                  | 648,107                        | 3,906,581           |
| Future income tax expense                                                     | 111,527                        | 385,008             |
| Non-controlling interest                                                      | -                              | 599,729             |
|                                                                               | 2,432,788                      | 2,981,255           |
| Changes in non-cash operating items                                           | (44,757)                       | (3,174,216)         |
| Tenant inducements and leasing expenditures incurred through leasing activity | -                              | (683,746)           |
|                                                                               | 2,388,031                      | (876,707)           |
| Proceeds of interim mortgage loan financing                                   | 15,500,000                     | 4,400,000           |
| Repayment of mortgage loans on refinancing                                    | (2,000,000)                    | (4,492,566)         |
| Repayment of interim mortgage loans                                           | (13,872,605)                   | (17,094,997)        |
| Repayment of principal on mortgage loans                                      | (1,436,791)                    | (2,714,926)         |
| Expenditures on transaction costs                                             | (605,969)                      | (857,829)           |
| Improvements to income properties                                             | (246,680)                      | (719,756)           |
| Proceeds of sale                                                              | 17,563,501                     | 29,631,650          |
| Decrease (increase) in restricted cash                                        | (403,393)                      | 359,972             |
| Decrease (increase) in properties under development                           | -                              | (98,658)            |
| Distributions paid on LP units of Village West LP                             | -                              | (33,285)            |
|                                                                               | 16,886,094                     | 7,502,898           |
| <b>Cash increase (decrease)</b>                                               | <b>(2,590,366)</b>             | <b>737,972</b>      |
| <b>Cash, beginning of year</b>                                                | <b>4,287,864</b>               | <b>3,549,892</b>    |
| <b>Cash, end of year</b>                                                      | <b>\$ 1,697,498</b>            | <b>\$ 4,287,864</b> |

Supplementary cash flow information (Note 22)

The accompanying notes are an integral part of these financial statements.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

#### **1 Organization**

Lanesborough Real Estate Investment Trust ("the Trust") is a closed-end real estate investment trust which was created under a Declaration of Trust dated April 23, 2002 and amended on June 12, 2006, June 18, 2008 and December 9, 2009.

#### **2 Basis of presentation and continuing operations**

The accompanying financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles ("GAAP"). These financial statements reflect the operations of the Trust and wholly owned operating subsidiaries and LREIT Village West Limited Partnership ("Village West LP"), an entity controlled by the Trust to November 9, 2009, when the Village West LP was dissolved. All inter-entity transactions have been eliminated.

The consolidated financial statements have been prepared on a going concern basis, which assumes the realization of assets and the settlement of liabilities for the next fiscal year.

The consolidated financial statements do not give effect to adjustments that would be necessary should the Trust be required to realize its assets in other than the normal course of business. The use of GAAP applicable to a going concern may be inappropriate as a result of the potential inability of the Trust to continue as a going concern. The Trust sustained losses from continuing operations of \$20,461,027 and \$15,666,433 for the years ended December 31, 2010 and 2009, respectively; has a working capital deficit of \$12,693,162 as at December 31, 2010 (December 31, 2009 - \$1,432,545 working capital); and was in breach of net operating income achievement and debt service coverage requirements on individual mortgage loans during the past 12 months and as of December 31, 2010.

The Trust is in breach of a net operating income achievement requirement for a \$23,386,597 first mortgage loan for six properties in Fort McMurray, Alberta. The Trust has notified the lender of the breach and is providing operating information to the lender on a monthly basis.

The Trust is in breach of a 1.15 debt service coverage requirement in regard to a first mortgage loan totaling \$21,693,020 on a property in Fort McMurray, Alberta. The Trust has notified the lender of the breach and is providing operating information to the lender on a monthly basis.

The Trust is in breach of the 1.2 times debt service coverage requirement of a first mortgage loan and a second mortgage loan totaling \$71,940,847, on three properties in Fort McMurray, Alberta. The Trust is also in breach of the 1.1 times debt service coverage requirement of a first mortgage loan of \$18,424,309, on a property in Fort McMurray, Alberta with the same lender. The lender provided forbearance to January 31, 2011 and management expects an initial extension of the forbearance will be provided to June 30, 2011.

The Trust is in breach of the 1.2 times debt service coverage requirement of a first mortgage loan of \$25,400,213, on one property in Fort McMurray, Alberta. The terms of the forbearance are under negotiation.

The breaches of the net operating income achievement and debt service coverage requirements on individual mortgage loans, as noted above, are a result of the negative impact of the 2009-2010 decline of development activities in the oil sands industry and the associated decline in the rental market conditions in Fort McMurray. Given that the rental market conditions may not improve substantially in the near future, all or some of the covenant breaches may continue for the next 12 months.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**2      *Basis of presentation and continuing operations (continued)***

The Trust is in breach of a covenant under a first mortgage loan which restricts the registration of a secondary mortgage charge. The first mortgage loan is in the amount \$20,064,829 and is registered against a property in Winnipeg, Manitoba. The Winnipeg property has been classified as held for sale. It is the intention of the Trust to sell the property within the next twelve months and use a portion of the proceeds to repay the first mortgage loan. The lender has demanded that the secondary mortgage charges be discharged by March 15, 2011. The Trust has not complied.

For the years ended December 31, 2009 and December 31, 2010, the Trust was in breach of the 1.3 times debt service coverage requirement of a \$4,976,540 first mortgage loan on a property in Moose Jaw, Saskatchewan. The Moose Jaw property has been classified as held for sale. The Trust has requested a forbearance letter from the lender. It is the intention of the Trust to sell this property within the next twelve months, and use a portion of the proceeds from sale to repay the first mortgage loan.

There are no cross-default covenants between the eight mortgages noted above and the other mortgage loans of the Trust.

The breaches of the net operating income achievement and debt service coverage requirements and the covenant restricting registration of secondary mortgage charges on individual mortgage loans have not resulted in an acceleration of the repayment of the mortgage loans. There is no assurance, however, that the lenders will not accelerate repayment of the mortgage loans.

As at December 31, 2010, mortgage loans in the amount of \$35,926,136 matured and had not been renewed or refinanced. Subsequent to December 31, 2010, a mortgage loan in the amount of \$1,991,574 and mortgage loans included in liabilities of properties held for sale in the amount of \$19,846,590 matured and has not yet been renewed or refinanced. Management is currently seeking renewals, extensions or refinancing on these mortgage loans and expects them to be achieved in the coming months. There is no assurance that the loans will be renewed or refinanced.

Continuation of operations is contingent upon improving cash flows from operations and in particular, the operating cash flows from the Fort McMurray portfolio, the completion of the divestiture program in a manner which achieves the targeted sales price and timelines, the continued ability of the Trust to renew or refinance its debt at maturity, including the amount payable on acquisition of Parsons Landing and the revolving loan from a related party, the ability of the Trust to successfully negotiate and extend forbearance arrangements for mortgages with covenant breaches; and the ability of the Trust to retire or refinance debenture debt at maturity.

Management believes that the going concern assumption is appropriate for the financial statements as the increasing economic activity in Fort McMurray is expected to result in improved occupancy levels, the Trust has successfully sold 18 properties, the Trust has successfully renewed mortgage loans at maturity and/or obtained forbearance arrangements, and the Trust has successfully retired the Series E and Series F debenture debt in 2010 and 2011.

If the going concern assumption is inappropriate, adjustments would be necessary to the carrying values of assets and liabilities and reported revenues and expenses used in these consolidated financial statements.



**LANESBOROUGH REAL ESTATE INVESTMENT TRUST****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009****3      *Significant accounting policies*****Use of estimates**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the date of the financial statements and the reported amounts of revenue and expenses during the year. Actual results could differ from those estimates and as adjustments become necessary, the adjustments are reported in earnings in the year in which the adjustments become known.

Significant items subject to estimates include the allocation of the total cost to income properties on acquisition, the transfer of amounts from properties under development to income properties, the remaining useful life of the income properties, undiscounted cash flows to be generated from income properties, the classification of properties held for sale, the calculation of future income tax assets and liabilities and the completion of the Parsons Landing acquisition.

**Income properties**

Income properties include land, buildings and related costs and improvements, furniture, equipment and appliances, tenant inducements and leasing expenses and intangible assets.

Income properties are carried at cost. Tenant inducements and leasing expenses that are incurred to obtain a lease are capitalized to the cost of buildings and improvements.

A portion of the total cost of acquisition of an income property is allocated to reflect the tenant origination costs (tenant inducements and leasing expenses) associated with in-place leases. A portion of the total cost of acquisition of an income property is also allocated to intangible assets to reflect the cost of lease origination costs, tenant relationships and above market leases.

If events or circumstances indicate that the carrying value of the income properties may be impaired, a recoverability analysis is performed based upon estimated undiscounted cash flows to be generated from the income properties. If the analysis indicates that the carrying value is not recoverable from future cash flows, the income properties are written down to estimated fair value and an impairment loss is recognized.

Amortization on buildings is recorded on a straight-line basis over their useful lives ranging from 25 to 50 years. Amortization of improvements is recorded on a straight-line basis over their remaining useful lives ranging from 5 to 25 years. Amortization of tenant inducements and leasing expenses is recorded on a straight-line basis over the term of the respective leases. Amortization of furniture, equipment and appliances is recorded on a straight-line basis over their remaining useful lives ranging from 5 to 15 years. Amortization of intangible assets is recorded on a straight-line basis over the term of respective leases.

**Properties under development**

Properties under development are carried at cost. Cost is comprised of acquisition costs, external and internal development and initial leasing costs, property operating costs and financing expenses less rental revenue incurred during the period of development prior to achieving a satisfactory level of occupancy within a predetermined time period.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**3 Significant accounting policies (continued)****Discontinued operations**

Assets and liabilities held for sale include the assets and liabilities of a property when the property is available for immediate sale; management has committed to a plan to sell the property and is actively locating a buyer at a sales price that is reasonable in relation to current fair value; and the sale is probable and expected to be completed within a one-year period. Properties held for sale are carried at the lower of cost and net realizable value, less selling costs. Amortization is not recorded on these properties once classified as held for sale. The results of operations associated with properties disposed of, or classified as held for sale, are reported separately as income from discontinued operations. The operations and cash flows of the property can be clearly distinguished, operationally and for financial purposes, and have been reported in discontinued operations.

**Convertible debentures**

Convertible debentures are separated into debt and equity components based on the respective fair values at the date of issue. The value of the equity component is calculated at the estimated fair value of the holders' options to convert the debentures into units. The value assigned to the debt component of convertible debentures represents the value of future interest and principal payments due under the terms of the debentures.

**Unit options**

The Trust has a unit option plan available for trustees, officers and employees of the Trust, as well as management company employees of the Trust, including Shelter Canadian Properties Limited and consultants retained by the Trust including investor relations consultants. Consideration paid by option holders on exercise of unit options is credited to Equity. The fair value based method of accounting is applied to all unit-based compensation. The fair value of the unit options granted is estimated on the date of grant using the Black-Scholes option pricing model. Compensation expense in regard to options granted to officers, employees and trustees is recognized over the vesting period of the options.

**Revenue recognition**

Rents are recognized as revenue over the terms of the related lease agreements. Rental revenue from leases with contractual rent increases is recognized on a straight-line basis over the term of the respective leases. The difference between the rental revenue recognized and the amount contractually due under the lease agreements is recorded to straight-line rent receivable and accrued rental revenue. Recoveries from tenants for property operating costs and property taxes are recognized as revenue during the year in which the applicable costs are incurred. Meal and other revenue is recognized as earned.

**Income taxes**

In accordance with the terms of the Declaration of the Trust, the Trust intends, whenever possible, to distribute its income for income tax purposes each year to such an extent that it will not be liable for income taxes under Part 1 of the Income Tax Act.

In June 2007, new legislation relating to, among other things, the federal income taxation of publicly traded income trusts was enacted. Under the new rules, certain distributions from a "specified investment flow-through" trust (a "SIFT") will no longer be deductible in computing a SIFT's taxable income, and a SIFT will be subject to tax on such distributions at a rate that is substantially equivalent to the general tax rate applicable to a Canadian corporation. Distributions paid as returns of capital will not be subjected to this tax.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

#### 3 *Significant accounting policies (continued)*

##### **Income taxes (continued)**

The new rules do not apply to a "real estate investment trust" that meets prescribed conditions relating to the nature of its income and investments (a "Qualifying REIT"). The new legislation does not apply to the Trust until 2011 as it provides for a transition period for publicly traded entities that existed prior to November 1, 2006. In the opinion of management, the Trust does not satisfy the prescribed conditions of a Qualifying REIT and will be treated as a SIFT for income tax purposes for the year ending December 31, 2011. During 2011, the Trust will consider its alternatives, including restructuring its affairs in order to meet the prescribed conditions and become a Qualifying REIT. The Trust has made no definitive decision in respect of any such restructuring. No assurance can be given that the Trust will restructure in the future or be able to restructure such that it will not be subject to tax imposed by the SIFT legislation, or that any such restructuring if implemented, would not result in material costs or other adverse consequences to the Trust of unitholders.

As the Trust does not meet the criteria for a Qualifying REIT, GAAP requires that the future income tax asset and liability calculation and estimates reflect its current income tax status.

In accordance with GAAP, the Trust and its wholly owned subsidiaries are required to: (i) determine its temporary differences between asset balances for income tax purposes and the balances recorded in accordance with GAAP; (ii) determine the periods over which those temporary differences are expected to reverse; and (iii) apply the tax rates enacted at the balance sheet date that will apply in the periods those temporary differences are expected to reverse. The Trust and its wholly owned subsidiaries are required to use reasonable estimates in completing the calculation and the result of the calculation is recorded as a future income tax asset, if the asset is more likely than not to be realized, or liability.

##### **Comprehensive income**

The Trust does not have any other comprehensive income or accumulated other comprehensive income.

##### **Per unit calculations**

Basic per unit amounts are calculated using the weighted average number of units outstanding during the year, including vested deferred units. Diluted per unit amounts are calculated after considering the potential exercise of convertible debentures, unvested deferred units, and outstanding unit options. The dilutive effect on per unit amounts resulting from outstanding unit options is calculated using the treasury stock method. Under this method, the diluted weighted average number of units is calculated assuming the proceeds that arise from the exercise of the outstanding options are used to purchase units of the Trust at their average market price for the period.

##### **Financial instruments**

All financial instruments are measured at fair value on initial recognition, except for certain related party transactions. Measurement in subsequent periods depends on whether the financial instrument has been classified as held for trading, available for sale, held to maturity, loans and receivables, or other liabilities.



## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**3 Significant accounting policies (continued)****Financial instruments (continued)**

Financial assets and financial liabilities classified as held-for-trading are measured at fair value with gains and losses recognized in net earnings. Financial assets classified as held-to-maturity, loans and receivables and other financial liabilities (other than those held-for-trading) are measured at amortized cost using the effective interest rate method of amortization. Available-for-sale financial assets are measured at fair value with unrealized gains and losses recognized in other comprehensive income. Investments in equity instruments classified as available-for-sale that do not have a quoted market price in an active market are measured at cost.

Net gains and losses arising from changes in fair value of held-to-maturity investments, loans and receivables and other financial liabilities are recognized in net income upon derecognition or impairment.

Derivative instruments are recorded on the balance sheet at fair value including those derivatives that are embedded in a financial instrument or other contract but are not closely related to the host financial instrument or contract, respectively. Changes in the fair values of derivative instruments are recognized in net earnings, except for derivatives that are designated as cash flow hedges, in which case the fair value change for the effective portion of such hedging relationships are recognized in other comprehensive income.

The Trust has designated its financial instruments, as follows:

| <u>Financial Statement Item</u>                | <u>Classification</u>       | <u>Measurement</u> |
|------------------------------------------------|-----------------------------|--------------------|
| Cash                                           | Held for trading            | Fair value         |
| Mortgage loans receivable                      | Loans and receivables       | Amortized cost     |
| Other assets                                   |                             |                    |
| Amounts receivable                             | Loans and receivables       | Amortized cost     |
| Restricted cash                                | Held for trading            | Fair value         |
| Defeasance assets                              | Held to maturity            | Amortized cost     |
| Mortgage loans payable                         | Other financial liabilities | Amortized cost     |
| Mortgage bonds                                 | Other financial liabilities | Amortized cost     |
| Accounts payable and accrued liabilities       |                             |                    |
| Interest rate swaps                            | Held for trading            | Fair value         |
| Other accounts payable and accrued liabilities | Other financial liabilities | Amortized cost     |
| Convertible debentures - debt component        | Other financial liabilities | Amortized cost     |
| Bank indebtedness                              | Other financial liabilities | Amortized cost     |
| Defeased liability                             | Other financial liabilities | Amortized cost     |

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. Transaction costs include fees and commissions paid to agents, advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs. Transaction costs are expensed as incurred for financial instruments classified or designated as held for trading. For other financial instruments, transaction costs are capitalized in the cost of the related asset or liability on initial recognition and are measured at amortized cost using the effective interest rate method.

The Trust assesses impairment of all financial assets, except those classified as held for trading. Management considers whether there has been a breach in contract, such as default of interest or principal payments in determining whether objective evidence of impairment exists. Impairment is measured as the difference between the asset's carrying value and its fair value. Impairment is included in current earnings.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**4** *Income properties*

| <u>December 31, 2010</u>            | <u>Cost</u>          | <u>Accumulated<br/>Amortization</u>     | <u>Net Book<br/>Value</u>     |
|-------------------------------------|----------------------|-----------------------------------------|-------------------------------|
| Land                                | \$ 63,712,848        | \$ -                                    | \$ 63,712,848                 |
| Buildings and improvements          | 318,316,870          | (25,861,612)                            | 292,455,258                   |
| Furniture, equipment and appliances | 9,843,604            | (4,239,427)                             | 5,604,177                     |
| Intangible assets                   | <u>207,222</u>       | <u>(181,502)</u>                        | <u>25,720</u>                 |
|                                     | <u>\$392,080,544</u> | <u>\$ (30,282,541)</u>                  | <u>\$361,798,003</u>          |
| <br><u>December 31, 2009</u>        | <br><u>Cost</u>      | <br><u>Accumulated<br/>Amortization</u> | <br><u>Net Book<br/>Value</u> |
| Land                                | \$ 63,712,848        | \$ -                                    | \$ 63,712,848                 |
| Buildings and improvements          | 318,002,882          | (18,642,658)                            | 299,360,224                   |
| Furniture, equipment and appliances | 9,819,404            | (2,965,798)                             | 6,853,606                     |
| Intangible assets                   | <u>207,222</u>       | <u>(160,935)</u>                        | <u>46,287</u>                 |
|                                     | <u>\$391,742,356</u> | <u>\$ (21,769,391)</u>                  | <u>\$369,972,965</u>          |

At December 31, 2010 and December 31, 2009, the carrying value of the income properties was not impaired.

**5** *Mortgage loans receivable*

|                                                                                                                                                                   | <u>December 31</u> |                     |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------|---------------------|
|                                                                                                                                                                   | <u>2010</u>        | <u>2009</u>         |
| Second mortgage loan receivable from Gill Apartments Ltd., due October 1, 2014. The loan bears interest at 5% and provides for monthly payments of interest only. | \$ 500,000         | \$ 500,000          |
| Second mortgage loan receivable from Mainstreet Equity Corp., due June 1, 2011.                                                                                   | <u>-</u>           | <u>6,550,000</u>    |
|                                                                                                                                                                   | <u>\$ 500,000</u>  | <u>\$ 7,050,000</u> |

**6** *Other assets*

|                                               | <u>December 31</u>   |                     |
|-----------------------------------------------|----------------------|---------------------|
|                                               | <u>2010</u>          | <u>2009</u>         |
| Restricted cash                               |                      |                     |
| Tenant security deposits                      | \$ 1,884,114         | \$ 1,687,002        |
| Reserves required by mortgage loan agreements | 9,511,409            | 1,299,723           |
| Mortgage bond proceeds held in escrow         | 8,947,815            | -                   |
| Sale proceeds in escrow                       | <u>-</u>             | <u>2,041,795</u>    |
|                                               | 20,343,338           | 5,028,520           |
| Amounts receivable                            | 632,275              | 523,761             |
| Prepaid expenses, deposits and other          | 850,325              | 1,227,621           |
| Deposits on potential acquisitions            | <u>10,000</u>        | <u>10,000</u>       |
|                                               | <u>\$ 21,835,938</u> | <u>\$ 6,789,902</u> |

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**6 Other assets (continued)**

Amounts receivable includes rent receivable of \$375,469 (2009 - \$401,742) net of an allowance for doubtful accounts of \$34,406 (2009 - \$90,680).

In accordance with the terms of the offering of mortgage bonds and warrants which closed on December 23, 2010, the net proceeds of such offering are held in escrow to partially fund the repayment of the Series F debentures at the March 11, 2011 maturity.

**7 Defeasance assets and defeased liability**

In conjunction with the sale of Woodlily Court on September 1, 2010, an existing \$2,818,509 mortgage loan payable was defeased. The defeased loan is due July 1, 2016, bears interest at 5.65%, is repayable in monthly payments of \$17,191 and is amortized over 30 years. The Trust purchased Government of Canada bonds, Government of Canada treasury bills and Canada mortgage bonds (hereafter "Defeasance Assets") in the amount of \$3,338,341 and pledged the Defeasance Assets as security to the debt holder. The Defeasance Assets mature on or before June 1, 2016, have a weighted average interest rate of 3.75% and have been placed in escrow. The Defeasance Assets and the defeased liability will be measured at amortized cost using the effective interest rate method of amortization until July 1, 2016 at which time the debt will be extinguished.

The following table reflects the effect of the Defeasance assets and the defeased liability.

|                                        |                           | Year Ended December 31 |             |
|----------------------------------------|---------------------------|------------------------|-------------|
| Recorded as                            |                           | 2010                   | 2009        |
| Interest income on defeasance assets   | Interest and other income | \$ 26,668              | \$ -        |
| Interest expense on defeased liability | Financing expense         | (52,344)               | -           |
| Amortization of transaction costs      | Financing expense         | (2,241)                | -           |
|                                        |                           | <u>\$ (27,917)</u>     | <u>\$ -</u> |

The unamortized balance of transaction costs in respect of the defeased liability is \$55,872 (2009 - nil).

**8 Properties held for sale and discontinued operations**

The Trust is pursuing a divestiture program. In this regard, the Trust has designated seven properties as held for sale (2009 - 12 properties held for sale).

In addition, the Trust is contractually obligated to apply the net proceeds of sale (after payment of sales expenses and mortgage debt) from the seven income properties held for sale to retire \$15.4 Million of interim mortgage loans payable (2009 - \$15.9 Million). In accordance with GAAP, the interim mortgage loans payable and the related interest expense are reflected in discontinued operations.



## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**8 Properties held for sale and discontinued operations (continued)**

The following table sets forth the assets and liabilities associated with income properties classified as held for sale.

|                                          | December 31          |                      |
|------------------------------------------|----------------------|----------------------|
|                                          | 2010                 | 2009                 |
| <b>Assets</b>                            |                      |                      |
| Income properties (a)                    | \$ 119,378,067       | \$ 146,486,369       |
| All other assets                         | <u>2,132,672</u>     | <u>2,557,466</u>     |
|                                          | <u>121,510,739</u>   | <u>149,043,835</u>   |
| <b>Liabilities</b>                       |                      |                      |
| Mortgage loans payable (b)               | 72,112,950           | 94,667,469           |
| Interim mortgage loans payable (c)       | 15,017,389           | 15,763,338           |
| Accounts payable and accrued liabilities | 3,633,384            | 4,301,424            |
| Future income taxes (f)                  | <u>3,284,075</u>     | <u>3,172,548</u>     |
|                                          | <u>94,047,798</u>    | <u>117,904,779</u>   |
| Net assets of properties held for sale   | <u>\$ 27,462,941</u> | <u>\$ 31,139,056</u> |

As at December 31, 2010, seven income properties met the held-for-sale criteria and as a result are reported in discontinued operations. In addition, the Trust sold five properties during the year ended December 31, 2010 (2009 - 13 properties sold). The results of operations from these properties have been disclosed below.

|                                             | Year Ended December 31 |                      |
|---------------------------------------------|------------------------|----------------------|
|                                             | 2010                   | 2009                 |
| <b>Revenue</b>                              |                        |                      |
| Rentals from income properties              | \$ 21,439,361          | \$ 30,737,245        |
| Interest and other income                   | <u>170,525</u>         | <u>137,736</u>       |
|                                             | 21,609,886             | 30,874,981*          |
| <b>Expenses</b>                             |                        |                      |
| Property operating costs                    | 12,677,758             | 16,847,464           |
| Financing expense (d)                       | 7,096,358              | 11,731,307           |
| Amortization (e)                            | 204,396                | 2,993,088            |
| Income tax expense - current and future (f) | <u>122,956</u>         | <u>603,772</u>       |
|                                             | 1,508,418              | (1,300,650)          |
| Non-controlling interest                    | <u>-</u>               | <u>(599,729)</u>     |
|                                             | 1,508,418              | (1,900,379)          |
| <b>Gain on sale</b>                         | <u>12,673,702</u>      | <u>21,063,885</u>    |
| <b>Income from discontinued operations</b>  | <u>\$ 14,182,120</u>   | <u>\$ 19,163,506</u> |

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**8 Properties held for sale and discontinued operations (continued)****(a) Income properties**

At December 31, 2010 and 2009, the carrying value of discontinued properties is not impaired.

**(b) Mortgage loans payable**

|                                                                                     | December 31          |                      |
|-------------------------------------------------------------------------------------|----------------------|----------------------|
|                                                                                     | 2010                 | 2009                 |
| Mortgage loan balances                                                              | \$ 72,125,757        | \$ 94,766,920        |
| Unamortized transaction costs                                                       | (12,807)             | (157,271)            |
| Difference between contract and market interest rates on mortgage loans assumed (d) | -                    | 57,820               |
|                                                                                     | <u>\$ 72,112,950</u> | <u>\$ 94,667,469</u> |

In accordance with GAAP, a mortgage is to be recorded at fair market value on the acquisition of a property and the difference between contractual and market interest rates is capitalized and amortized over the term of the respective mortgage.

Certain of the mortgage loans payable are subject to covenants, including debt service coverage requirements and restrictions on the registration of secondary charges against the title to the property. The Trust is not in compliance with a \$4,976,540 first mortgage loan, as a result of a breach of the debt service coverage requirement and is not in compliance with a \$20,064,829 first mortgage loan, as a result of the registration of secondary charges against the title to the property.

With the exception of two mortgage loans in the aggregate amount of \$19,846,540, all of the mortgage loans payable, which have matured prior to March 28, 2011, have been renewed or refinanced. Management expects that the two mortgage loans will be renewed or refinanced on similar terms.

**(c) Interim mortgage loans payable**

|                                | December 31          |                      |
|--------------------------------|----------------------|----------------------|
|                                | 2010                 | 2009                 |
| Interim mortgage loan balances | \$ 15,445,000        | \$ 15,872,605        |
| Unamortized transaction costs  | (427,611)            | (109,267)            |
|                                | <u>\$ 15,017,389</u> | <u>\$ 15,763,338</u> |

**(d) Financing expense**

|                                       | Year Ended December 31 |                      |
|---------------------------------------|------------------------|----------------------|
|                                       | 2010                   | 2009                 |
| Mortgage loan interest                | 6,594,827              | 10,767,624           |
| Amortization of transaction costs (e) | 501,531                | 963,683              |
|                                       | <u>\$ 7,096,358</u>    | <u>\$ 11,731,307</u> |

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**8 Properties held for sale and discontinued operations (continued)**

| (e) Amortization                                                                    | Year Ended December 31 |                     |
|-------------------------------------------------------------------------------------|------------------------|---------------------|
|                                                                                     | 2010                   | 2009                |
| Building                                                                            | \$ 191,692             | \$ 2,454,739        |
| Furniture, equipment and appliances                                                 | 12,704                 | 183,260             |
| Intangible assets, except for in-place leases                                       | -                      | 355,089             |
| Mortgage guarantee fees                                                             | -                      | -                   |
|                                                                                     | <u>204,396</u>         | <u>2,993,088</u>    |
| Transaction costs (d)                                                               | 501,531                | 963,683             |
| Difference between contract and market interest rates on mortgage loans assumed (b) | (57,820)               | (52,978)            |
| Above market in-place leases                                                        | -                      | 3,129               |
| Below market in-place leases                                                        | -                      | (341)               |
|                                                                                     | <u>\$ 648,107</u>      | <u>\$ 3,906,581</u> |

**(f) Future income taxes**

Future income taxes consists of the following components:

|                                                                                                                                      | December 31           |                       |
|--------------------------------------------------------------------------------------------------------------------------------------|-----------------------|-----------------------|
|                                                                                                                                      | 2010                  | 2009                  |
| <b>Future income tax asset relating to the assets of the Trust:</b>                                                                  |                       |                       |
| Future income tax asset relating to the temporary difference between the accounting and tax basis for:                               |                       |                       |
| Income properties                                                                                                                    | \$ 237,987            | \$ 793,898            |
| Transaction costs                                                                                                                    | <u>120,383</u>        | <u>102,498</u>        |
|                                                                                                                                      | 358,370               | 896,396               |
| Valuation allowance                                                                                                                  | <u>(358,370)</u>      | <u>(896,396)</u>      |
|                                                                                                                                      | <u>\$ -</u>           | <u>\$ -</u>           |
| <b>Future income tax liability relating to the wholly owned subsidiaries:</b>                                                        |                       |                       |
| Future income tax asset (liability) relating to the temporary differences between the accounting and tax basis for income properties | \$ (2,940,530)        | \$ (2,773,834)        |
| Future income tax asset relating to operating losses of the wholly owned subsidiaries                                                | <u>2,387,335</u>      | <u>2,273,348</u>      |
|                                                                                                                                      | (553,195)             | (500,486)             |
| Valuation allowance                                                                                                                  | <u>(2,730,880)</u>    | <u>(2,672,062)</u>    |
|                                                                                                                                      | <u>\$ (3,284,075)</u> | <u>\$ (3,172,548)</u> |

In recognition of the uncertainty with respect to the realization of the income tax assets, a valuation allowance was recorded to reduce the future income tax assets to nil at December 31, 2010 and 2009.



## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 20098 *Properties held for sale and discontinued operations (continued)*(f) **Future income taxes (continued)**

|                                                                                                                                   | Year Ended December 31 |             |
|-----------------------------------------------------------------------------------------------------------------------------------|------------------------|-------------|
|                                                                                                                                   | 2010                   | 2009        |
| <b>Income tax expense:</b>                                                                                                        |                        |             |
| <b>Trust</b>                                                                                                                      |                        |             |
| Decrease (increase) in future income tax asset resulting from a change in temporary differences relating to:                      |                        |             |
| Income properties                                                                                                                 | \$ 519,298             | \$ (63,733) |
| Transaction costs                                                                                                                 | (36,405)               | (135,448)   |
| Change in tax rate                                                                                                                | 55,133                 | -           |
|                                                                                                                                   | 538,026                | (199,181)   |
| Valuation allowance                                                                                                               | (538,026)              | 929,808     |
| Future income taxes                                                                                                               | -                      | 730,627     |
| <b>Wholly owned subsidiaries</b>                                                                                                  |                        |             |
| Increase (decrease) in future income tax liability resulting from a change in temporary differences relating to income properties | 284,416                | (676,981)   |
| Increase (decrease) in future income tax liability resulting from changes in tax rates                                            | 322,021                | (18,202)    |
| Increase in future income tax asset resulting from operating losses                                                               | (553,728)              | (752,924)   |
|                                                                                                                                   | 52,709                 | (1,448,107) |
| Valuation allowance                                                                                                               | 58,818                 | 1,102,488   |
| Future income taxes                                                                                                               | 111,527                | (345,619)   |
| Current income taxes at statutory tax rates                                                                                       | 11,429                 | 218,764     |
|                                                                                                                                   | 122,956                | (126,855)   |
| Income tax expense - future and current                                                                                           | \$ 122,956             | \$ 603,772  |

Income tax expense future and current is comprised of the following:

|                                                  | Year Ended December 31 |            |
|--------------------------------------------------|------------------------|------------|
|                                                  | 2010                   | 2009       |
| Future income taxes - Trust                      | \$ -                   | \$ 730,627 |
| Future income taxes - Wholly owned subsidiaries  | 111,527                | (345,619)  |
|                                                  | 111,527                | 385,008    |
| Current income taxes - Wholly owned subsidiaries | 11,429                 | 218,764    |
| Income tax expense - future and current          | \$ 122,956             | \$ 603,772 |

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**8 Properties held for sale and discontinued operations (continued)****(f) Future income taxes (continued)**

The wholly owned subsidiaries have the following operating losses available to reduce income for tax purposes in future years. The potential benefit of these losses has not been reflected in the consolidated financial statements.

Operating losses carried forward expiring in:

|      |                     |
|------|---------------------|
| 2026 | \$ 113,256          |
| 2027 | 2,353,597           |
| 2028 | 2,437,741           |
| 2029 | 2,431,870           |
| 2030 | <u>1,788,663</u>    |
|      | <u>\$ 9,125,127</u> |

**9 Mortgage loans payable**

|                               | <u>Weighted average interest rates</u> |      |                       |                       |
|-------------------------------|----------------------------------------|------|-----------------------|-----------------------|
|                               | December 31                            |      | December 31           |                       |
|                               | 2010                                   | 2009 | 2010                  | 2009                  |
| <b>First mortgage loans</b>   |                                        |      |                       |                       |
| Fixed rate                    | 5.7%                                   | 5.7% | \$ 187,348,601        | \$ 190,807,999        |
| Variable rate                 | 6.8%                                   | 6.0% | <u>54,439,020</u>     | <u>55,000,000</u>     |
| Total first mortgage loans    | 6.0%                                   | 5.8% | <u>241,787,621</u>    | <u>245,807,999</u>    |
| <b>Second mortgage loans</b>  |                                        |      |                       |                       |
| Fixed rate                    | 7.5%                                   | 8.6% | 500,000               | 9,000,000             |
| Variable rate                 | 6.5%                                   | 5.8% | <u>17,501,827</u>     | <u>17,766,738</u>     |
| Total second mortgage loans   | 6.5%                                   | 6.8% | <u>18,001,827</u>     | <u>26,766,738</u>     |
| <b>Total</b>                  | 6.0%                                   | 5.9% | 259,789,448           | 272,574,737           |
| Unamortized transaction costs |                                        |      | <u>(1,076,258)</u>    | <u>(1,160,667)</u>    |
|                               |                                        |      | <u>\$ 258,713,190</u> | <u>\$ 271,414,070</u> |

The Trust has entered into interest rate swap arrangements whereby the interest rate on the floating rate mortgages in the amounts of \$19,545,006 and \$21,693,020, have fixed rates of 5.74% and 5.82% and mature in 2013 and 2018, respectively.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**9 Mortgage loans payable (continued)**

Approximate principal repayments are as follows:

| Year ending December 31 |                      |
|-------------------------|----------------------|
| 2011                    | \$166,615,440        |
| 2012                    | 31,153,231           |
| 2013                    | 39,031,649           |
| 2014                    | 9,201,245            |
| 2015                    | 6,165,818            |
| Thereafter              | <u>7,622,065</u>     |
|                         | <u>\$259,789,448</u> |

Mortgage loans are secured by mortgage charges registered against specific income properties and are secured by assignments of book debts and rents and by repayment guarantees.

Certain of the mortgage loans payable are subject to covenants, including net operating income and minimum debt service coverage requirements. The Trust is not in compliance with five first mortgage loans and one second mortgage loan totaling \$160,844,986, as a result of a breach of covenant requirements in respect of the mortgage loans. In accordance with GAAP the total loan balance of \$160,844,986 is included in principal repayments in 2011.

Two of the above noted mortgage loans in breach of debt coverage requirements, in the aggregate amount of \$35,926,136, matured in 2010 and have not been renewed. The maturity dates have not been extended and the loans are payable on demand. A forbearance to January 31, 2011 has been obtained for both loans and an initial extension to June 30, 2011 is expected.

With the exception of a \$1,991,574 mortgage loan which matured January 1, 2011, all mortgage loans which matured subsequent to January 1, 2011 have been renewed or refinanced. Management expects that the mortgage loan will be renewed or refinanced on similar terms.

**10 Mortgage bonds and warrants**

On March 9, 2010, the Trust issued 6,780 five year 9% mortgage bonds in the principal amount of \$1,000, due March 10, 2015, and 6,780,000 in warrants for gross proceeds of \$6,780,000. Each warrant entitles the holder to purchase one unit at a price of \$1.00 until March 9, 2015.

On the issue date, the value of the warrants was established using the Black Scholes option pricing model using a risk free interest rate of 2.69% over the expected life of 5 years with an expected volatility rate of 50% and an expected dividend yield of nil. The value of the warrants in the amount of \$2,111,984 was recognized in equity and the residual amount of \$4,668,016, representing the value of the mortgage bonds, was recognized in liabilities.

In December 2010, the mortgage bonds were redeemed using proceeds from property sales and the December 23, 2010 mortgage bond issue. At redemption, \$1,895,913 of accretion and \$838,423 of unamortized transaction costs were recorded to financing expense. The warrants related to the March 9, 2010 mortgage bond issue continue to be exercisable until their expiry.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**10 Mortgage bonds and warrants (continued)**

On December 23, 2010, the Trust issued 12,637 five year 9% mortgage bonds in the principal amount of \$1,000, due December 24, 2015, and 12,637,000 in warrants for gross proceeds of \$12,637,000. Each warrant entitles the holder to purchase one unit at a price of \$0.75 until December 23, 2015. The mortgage bonds are secured by second mortgage charges registered against five income properties with a book value of \$37,285,440.

On the issue date, the value of the warrants was established using the Black Scholes option pricing model using a risk free interest rate of 2.56% over the expected life of 5 years with an expected volatility rate of 71% and an expected dividend yield of nil. The value of the warrants in the amount of \$2,190,000 was recognized in equity and the residual amount of \$10,447,000, representing the value of the mortgage bonds, was recognized in liabilities.

The face value of the mortgage bonds is \$12,637,000 and the carrying value is calculated as follows:

|                               |                     |
|-------------------------------|---------------------|
| Value at issue                | \$ 10,447,000       |
| Accretion                     | 7,939               |
| Unamortized transaction costs | <u>(1,137,864)</u>  |
|                               | <u>\$ 9,317,075</u> |

Accretion for the year ended December 31, 2010 of \$7,939 (2009 - nil) is included in financing expense.

**11 Convertible debentures**

The face value of the outstanding convertible debentures is as follows:

|          | December 31          |                      |
|----------|----------------------|----------------------|
|          | 2010                 | 2009                 |
| Series E | \$ -                 | \$ 11,950,000        |
| Series F | 13,601,000           | 13,680,000           |
| Series G | <u>25,595,000</u>    | <u>25,732,000</u>    |
|          | <u>\$ 39,196,000</u> | <u>\$ 51,362,000</u> |

During the years ended December 31, 2010 and 2009, there have not been any conversions of convertible debentures.

The allocation of the convertible debentures to debt and equity components is based on the net present value of future interest and principal payments with an estimated cost of borrowing without conversion option of 15% for Series E, Series F and Series G debentures.

| <u>December 31, 2010</u>               | <u>Debt</u>          | <u>Equity</u>        | <u>Total</u>         |
|----------------------------------------|----------------------|----------------------|----------------------|
| Convertible debentures                 |                      |                      |                      |
| Series F - 7.5%, due March 11, 2011    | \$ 13,464,400        | \$ 3,543,792         | \$ 17,008,192        |
| Series G - 7.5%, due December 31, 2011 | <u>23,948,528</u>    | <u>6,668,875</u>     | <u>30,617,403</u>    |
|                                        | 37,412,928           | 10,212,667           | 47,625,595           |
| Unamortized transaction costs          | <u>(426,282)</u>     | <u>-</u>             | <u>(426,282)</u>     |
|                                        | <u>\$ 36,986,646</u> | <u>\$ 10,212,667</u> | <u>\$ 47,199,313</u> |



## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**11 Convertible debentures (continued)**

| <u>December 31, 2009</u>               | <u>Debt</u>          | <u>Equity</u>        | <u>Total</u>         |
|----------------------------------------|----------------------|----------------------|----------------------|
| Convertible debentures                 |                      |                      |                      |
| Series E - 8%, due February 17, 2010   | \$ 11,814,795        | \$ 2,835,690         | \$ 14,650,485        |
| Series F - 7.5%, due March 11, 2011    | 12,587,225           | 3,564,376            | 16,151,601           |
| Series G - 7.5%, due December 31, 2011 | <u>22,541,667</u>    | <u>6,704,571</u>     | <u>29,246,238</u>    |
|                                        | 46,943,687           | 13,104,637           | 60,048,324           |
| Unamortized transaction costs          | <u>(1,002,844)</u>   | <u>-</u>             | <u>(1,002,844)</u>   |
|                                        | <u>\$ 45,940,843</u> | <u>\$ 13,104,637</u> | <u>\$ 59,045,480</u> |

The accretion of the debt component for the year ended December 31, 2010 of \$2,617,912 (2009 - \$2,853,290), which increases the debt component from the initial carrying amount, is included in financing expense.

Subsequent to December 31, 2010, the Series F debentures with a face value of \$13,601,000 were paid in full.

In January 2010, LREIT initiated normal course issuer bids for the Series F debentures and Series G debentures, under which the Trust is entitled to purchase up to \$1,368,000 of Series F debentures and up to \$2,573,000 of Series G debentures. The normal course issuer bids commenced on January 13, 2010 and expired on January 12, 2011.

In January 2011, LREIT renewed its normal course issuer bid for the Series G debentures, under which, the Trust is entitled to purchase up to \$2,557,000 of Series G debentures. The normal course issuer bid commenced January 13, 2011 and expires on December 31, 2011.

During the period from January 13, 2010 to December 31, 2010, the Trust purchased and cancelled Series F debentures with a face value of \$79,000 at an average price of \$89.29 per \$100.00 and Series G debentures with a face value of \$137,000 at an average price of \$73.47 per \$100.00. Subsequent to December 31, 2010, the Trust purchased and cancelled Series F debentures with a face value of \$3,000 at an average price of \$98.00 per \$100.00 and Series G debentures with a face value of \$44,000 at an average price of \$76.82 per \$100.00. The Trust is not required to purchase any debentures under the normal course issuer bids.

In accordance with the terms of the trust indenture for the Series G debentures, the Trust has an option to retire the debentures, in whole or in part, by the issue of units, on the maturity of the Series G debentures.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**12     *Accounts payable and accrued liabilities***

|                                           | December 31          |                      |
|-------------------------------------------|----------------------|----------------------|
|                                           | 2010                 | 2009                 |
| Accounts payable and accrued liabilities  | \$ 3,654,449         | \$ 1,444,635         |
| Revolving loan from 2668921 Manitoba Ltd. | 7,350,000            | -                    |
| Payable on acquisition of Parsons Landing | 47,720,000           | 47,720,000           |
| Construction costs payable                | 333,831              | 1,134,621            |
| Interest payable                          | 1,511,906            | 1,746,778            |
| Mortgage guarantee fees payable           | 73,074               | 290,667              |
| Tenant security deposits                  | 1,900,493            | 1,702,088            |
| Interest rate swaps                       | 3,594,573            | 6,306,198            |
|                                           | <u>\$ 66,138,326</u> | <u>\$ 60,344,987</u> |

The amount payable on the acquisition of Parsons Landing includes the acquisition cost payable in the amount of \$45,233,000.

**Interest rate swaps**

The Trust entered into interest rate swap arrangements whereby the interest rate on the floating rate mortgages have been fixed for the five and ten year terms of the mortgages. The interest rate swaps are derivative financial instruments classified as held-for-trading and are recorded on the balance sheet at fair value. The fair value of the swap liability decreased by \$2,711,625 for the year ended December 31, 2010 (2009 - \$2,293,795 increase). The effect of the change in value of interest rate swaps is included in financing expense.

**13     *Bank indebtedness***

Bank indebtedness consists of a revolving line of credit that the Trust obtained from a Canadian chartered bank in the maximum amount of \$5,000,000, bearing interest at prime plus 3.5% (2009 - prime plus 3.5%) and repayable on demand. The line of credit is secured by a second mortgage on an income property. The amount available on the line of credit is reduced by \$125,000 relating to the issue of a letter of credit. As at December 31, 2010, \$1,915,000 was available to the Trust (2009 - \$4,875,000).

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009

## 14 Units

The number of units issued, and purchased and cancelled, are as follows:

|                                                        | Year Ended<br>December 31, 2010 |                      | Year Ended<br>December 31, 2009 |                      |
|--------------------------------------------------------|---------------------------------|----------------------|---------------------------------|----------------------|
|                                                        | Units                           | Amount               | Units                           | Amount               |
| Outstanding, beginning of year                         | 17,893,767                      | \$ 98,966,638        | 17,588,081                      | \$ 77,661,519        |
| Exchange of deferred units                             | 94,572                          | 79,317               | -                               | -                    |
| Units issued on payment of distributions               | -                               | 8,814,286            | -                               | 19,504,206           |
| Issued on distribution reinvestment plan               | -                               | -                    | 48,576                          | 108,517              |
| Issue costs                                            | -                               | -                    | -                               | (6,502)              |
| Purchased and cancelled under normal course issuer bid | -                               | -                    | (99,507)                        | (440,804)            |
| Exchange of Village West Class B LP units              | -                               | -                    | 356,617                         | 2,139,702            |
| Outstanding, end of year                               | <u>17,988,339</u>               | <u>\$107,860,241</u> | <u>17,893,767</u>               | <u>\$ 98,966,638</u> |

**Units issued on payment of distribution**

As a result of realized capital gains, the Trust paid a "special" distributions in the form of additional units on December 31, 2009 and December 31, 2010. The distributions were followed by an immediate consolidation of units resulting in Unitholders holding the same number of units after the distributions as were held prior to the distributions.

**Distribution Reinvestment Plan**

Pursuant to the distribution reinvestment plan ("DRIP"), holders of units may elect to have all or a portion of their distributions automatically reinvested in additional units. Participants in the DRIP receive a bonus distribution of units equal to 4% of the amount of the cash distribution which is reinvested. The purchase price of the units is equal to the weighted average closing price of the units for the five trading days immediately preceding the distribution payment date. During the year ended December 31, 2010, nil (2009 - 48,576) units have been issued pursuant to the DRIP.

**Units purchased and cancelled under normal course issuer bid**

The Trust maintains a normal course issuer bid to acquire up to 1,368,158 units over the twelve month period ending January 12, 2011.

Units purchased by the Trust under its normal course issuer bid are cancelled. During the year ended December 31, 2010 the Trust did not purchase and cancel any units under the normal course issuer bid. During the year ended December 31, 2009, the Trust purchased and cancelled 99,507 units under the normal course issuer bid at a weighted average price of \$2.77 per unit.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 200915 *Unit option plan*

The Trust may grant options to the Trustees, senior officers and consultants of the Trust. The maximum number of units reserved for issuance under the unit option plan will be limited to 5% of the total number of issued and outstanding units. The Trustees shall set the exercise price at the time that an option is granted under the plan, which exercise price shall not be less than the current market price of the units as determined under the policies of the Exchange on the date of grant. The options will have a maximum term of five years from the date of grant.

The fair value of each unit option granted is estimated on the date of grant using the Black-Scholes option pricing model.

Unit-based compensation expense for the year ended December 31, 2010 of \$41,521 (2009 - \$104,355), relating to options issued was recorded to expense the fair value unit-based compensation. Unit-based compensation is included in trust expense.

A summary of the status of the unit options and changes during the period is as follows:

|                                  | Year Ended<br>December 31, 2010 |                                       | Year Ended<br>December 31, 2009 |                                       |
|----------------------------------|---------------------------------|---------------------------------------|---------------------------------|---------------------------------------|
|                                  | Units                           | Weighted<br>Average<br>Exercise Price | Units                           | Weighted<br>Average<br>Exercise Price |
| Outstanding, beginning of period | 1,452,000                       | \$ 5.56                               | 1,452,000                       | \$ 5.56                               |
| Cancelled, March 29, 2010        | (357,500)                       | 5.60                                  | -                               | -                                     |
| Cancelled, April 1, 2010         | (5,000)                         | 5.80                                  | -                               | -                                     |
| Cancelled, April 1, 2010         | (1,500)                         | 5.10                                  | -                               | -                                     |
| Cancelled, September 12, 2010    | (1,500)                         | 5.10                                  | -                               | -                                     |
| Cancelled, September 12, 2010    | (5,000)                         | 5.80                                  | -                               | -                                     |
| Cancelled, September 16, 2010    | (110,000)                       | 5.47                                  | -                               | -                                     |
| Cancelled, October 8, 2010       | (3,000)                         | 5.10                                  | -                               | -                                     |
| Outstanding, end of period       | <u>968,500</u>                  | <u>\$ 5.58</u>                        | <u>1,452,000</u>                | <u>\$ 5.56</u>                        |
| Vested, end of period            | <u>912,100</u>                  |                                       | <u>1,156,800</u>                |                                       |

At December 31, 2010 the following unit options were outstanding:

| Exercise price | Options outstanding | Options vested | Expiry date      |
|----------------|---------------------|----------------|------------------|
| \$ 5.42        | 22,500              | 22,500         | January 17, 2011 |
| 5.80           | 625,000             | 625,000        | July 26, 2011    |
| 5.30           | 90,000              | 90,000         | June 8, 2012     |
| 5.10           | <u>231,000</u>      | <u>174,600</u> | January 7, 2013  |
|                | <u>968,500</u>      | <u>912,100</u> |                  |



**LANESBOROUGH REAL ESTATE INVESTMENT TRUST****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009****16      *Deferred unit plan***

The Trust has adopted a deferred unit plan, under which, any trustee, officer, employee, or consultant employee of the Trust may elect to have their annual bonus, annual board retainer or board meeting fees payable to that person by the Trust paid, in whole or in part, in the form of deferred units. The number of deferred units received by a participant is determined by dividing the amount of the annual bonus, annual board retainer or board meeting fees, as applicable, to be paid in the form of deferred units on that date by the fair market value of the Trust's units.

Deferred units granted to Trustees shall vest immediately. Deferred units granted to participants other than Trustees shall vest 33% on the first anniversary of grant, 33% on the second anniversary of grant, and 34% on the third anniversary of grant. In the event of any change of control, any unvested deferred units shall vest upon the earlier of the next applicable vesting date and the date that is immediately prior to the date upon which the change of control is completed. The board shall have the discretion to vary the manner in which deferred units vest for any participant.

The deferred units credited to a participant (including deferred units that have not yet vested) shall vest immediately and be redeemable by the participant following the termination other than for cause, retirement, or death, of the participant. In the event that a participant is terminated for cause, only the deferred units that have vested shall be redeemable and any unvested deferred units shall be cancelled.

Whenever cash distributions are paid on the units of the Trust, additional deferred units will be credited to the participant based on the number of deferred units held, the amount of the distribution and the market value of a unit of the Trust on the date of the distribution. Additional deferred units shall vest at the same time and on the same basis as the deferred units in respect of which they are credited.

Deferred units granted to Trustees, and fully vested, totaled 248,281 for the year ended December 31, 2010 (2009 - 221,910) and 399,419 aggregate deferred units were outstanding at December 31, 2010 (2009 - 245,710).

Unit-based compensation expense of \$134,750 for the year ended December 31, 2010 (2009 - \$178,094) relating to deferred units granted was recorded to expense the fair value unit-based compensation. Unit-based compensation is recorded in Trust expense.

During 2010, 94,572 units, with a value of \$79,317, were issued on the exchange of deferred units upon resignation of a Trustee.

**17      *Rentals from income properties***

Rental revenue contractually due from tenants includes the recovery of property operating costs and property taxes from tenants of \$920,449 for the year ended December 31, 2010 (2009 - \$1,408,924).

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**18**     *Financing expense*

|                                                           | Year Ended December 31 |                      |
|-----------------------------------------------------------|------------------------|----------------------|
|                                                           | 2010                   | 2009                 |
| Interest on acquisition payable:                          |                        |                      |
| Interest charged                                          | \$ 10,510,317          | \$ 9,918,409         |
| Forgiveness of interest                                   | <u>(6,910,317)</u>     | <u>(5,841,638)</u>   |
|                                                           | 3,600,000              | 4,076,771            |
| Mortgage loan interest                                    | 16,479,399             | 14,738,704           |
| Mortgage bond interest                                    | 530,334                | -                    |
| Accretion of mortgage bonds                               | 2,119,923              | -                    |
| Defeased liability interest                               | 52,344                 | -                    |
| Convertible debenture interest                            | 3,076,585              | 3,911,900            |
| Accretion of the debt component of convertible debentures | 2,617,912              | 2,853,290            |
| Amortization of transaction costs                         | 3,028,241              | 1,193,979            |
| Change in fair value of interest rate swaps               | <u>(2,711,625)</u>     | <u>2,293,795</u>     |
|                                                           | <u>\$ 28,793,113</u>   | <u>\$ 29,068,439</u> |

Upon the repayment of the March 6, 2010 mortgage bonds, \$1,895,913 of accretion and \$838,423 of unamortized transaction costs were recorded to financing expense.

**19**     *Amortization*

|                                               | Year Ended December 31 |                     |
|-----------------------------------------------|------------------------|---------------------|
|                                               | 2010                   | 2009                |
| Building                                      | \$ 7,218,954           | \$ 7,176,140        |
| Furniture, equipment and appliances           | 1,273,620              | 1,269,267           |
| Intangible assets, except for in-place leases | <u>20,573</u>          | <u>20,573</u>       |
|                                               | 8,513,147              | 8,465,980           |
| Transaction costs                             | <u>3,028,241</u>       | <u>1,193,979</u>    |
|                                               | <u>\$ 11,541,388</u>   | <u>\$ 9,659,959</u> |

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**20 Future income taxes**

Future income taxes consists of the following components:

|                                                                                                              | December 31            |                     |
|--------------------------------------------------------------------------------------------------------------|------------------------|---------------------|
|                                                                                                              | 2010                   | 2009                |
| <b>Future income tax asset relating to the assets of the Trust:</b>                                          |                        |                     |
| Future income tax asset relating to the temporary difference between the accounting and tax basis for:       |                        |                     |
| Income properties                                                                                            | \$ 3,939,390           | \$ 7,000,636        |
| Transaction costs                                                                                            | 179,466                | (136,185)           |
|                                                                                                              | 4,118,856              | 6,864,451           |
| Valuation allowance                                                                                          | (4,118,856)            | (6,864,451)         |
|                                                                                                              | <u>\$ -</u>            | <u>\$ -</u>         |
|                                                                                                              |                        |                     |
|                                                                                                              | Year Ended December 31 |                     |
|                                                                                                              | 2010                   | 2009                |
| <b>Future income tax expense (recovery):</b>                                                                 |                        |                     |
| Decrease (increase) in future income tax asset resulting from a change in temporary differences relating to: |                        |                     |
| Income properties                                                                                            | \$ 2,455,186           | \$(4,211,816)       |
| Transaction costs                                                                                            | (343,262)              | 79,581              |
| Change in tax rates                                                                                          | 633,671                | -                   |
|                                                                                                              | 2,745,595              | (4,132,235)         |
| Valuation allowance                                                                                          | (2,745,595)            | 6,831,039           |
|                                                                                                              | <u>\$ -</u>            | <u>\$ 2,698,804</u> |

In recognition of the uncertainty with respect to the realization of the income tax assets, a valuation allowance was recorded to reduce the future income tax asset to nil at December 31, 2010.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**21 Per unit calculations**

Basic per unit information is calculated based on the weighted average number of units outstanding for the year, including vested deferred units. Diluted per unit information is calculated based on the weighted average diluted number of units for the year, considering the dilutive effect of unvested deferred units, the potential exercise of outstanding unit options to the extent that the unit options are dilutive and the potential conversion of outstanding convertible debentures and warrants to the extent that the debentures and the warrants are dilutive.

Income (loss) per unit calculations are based on the following:

**Continuing Operations**

|                                         | Year Ended December 31 |                        |
|-----------------------------------------|------------------------|------------------------|
|                                         | 2010                   | 2009                   |
| Income (loss) and diluted income (loss) | <u>\$ (20,461,027)</u> | <u>\$ (15,666,433)</u> |
| Weighted average number of:             |                        |                        |
| Units                                   | 17,941,183             | 17,465,519             |
| Deferred units                          | <u>323,553</u>         | <u>72,851</u>          |
| Total, basic and diluted                | <u>18,264,736</u>      | <u>17,538,370</u>      |

**Discontinued Operations**

|                             | Year Ended December 31 |                      |
|-----------------------------|------------------------|----------------------|
|                             | 2010                   | 2009                 |
| Income and diluted income   | <u>\$ 14,182,120</u>   | <u>\$ 19,163,506</u> |
| Weighted average number of: |                        |                      |
| Units                       | 17,941,183             | 17,465,519           |
| Deferred units              | <u>323,553</u>         | <u>72,851</u>        |
| Total, basic and diluted    | <u>18,264,736</u>      | <u>17,538,370</u>    |



## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**22** *Supplementary cash flow information*

|                                           | Year Ended December 31 |                      |
|-------------------------------------------|------------------------|----------------------|
|                                           | 2010                   | 2009                 |
| <b>Interest paid on:</b>                  |                        |                      |
| Acquisition payable                       | <u>\$ 3,600,000</u>    | <u>\$ 4,076,771</u>  |
| Mortgage loans                            | <u>\$ 16,501,599</u>   | <u>\$ 15,642,725</u> |
| Mortgage bonds                            | <u>\$ 502,290</u>      | <u>\$ -</u>          |
| Convertible debentures                    | <u>\$ 3,427,741</u>    | <u>\$ 3,911,900</u>  |
| <b>Interest received on:</b>              |                        |                      |
| Mortgage loans receivable                 | <u>\$ 346,905</u>      | <u>\$ -</u>          |
| Other                                     | <u>\$ 380,355</u>      | <u>\$ 396,597</u>    |
| <b>Cash distributions</b>                 |                        |                      |
| Distributions declared                    | \$ 8,814,286           | \$ 21,139,285        |
| Distributions paid in units               | (8,814,286)            | (19,504,206)         |
| Distributions to participants in the DRIP | <u>-</u>               | <u>(104,343)</u>     |
| Distributions paid in cash                | <u>\$ -</u>            | <u>\$ 1,530,736</u>  |

**23** *Distribution of taxable income*

In accordance with the Declaration of Trust, the Trust intends, but is not obligated, to make distributions in an amount equal to the aggregate of taxable income from operations and realized capital gains, net of any realized capital losses.

The following table reflects a comparison of taxable income to distributions declared.

|                        | Year Ended December 31 |                      |
|------------------------|------------------------|----------------------|
|                        | 2010                   | 2009                 |
| Realized capital gains | <u>\$ 8,860,436</u>    | <u>\$ 19,153,410</u> |
| Taxable capital gains  | \$ 4,430,218           | \$ 9,576,705         |
| Rental income (loss)   | <u>(3,869,049)</u>     | <u>-</u>             |
| Taxable income         | <u>\$ 561,169</u>      | <u>\$ 9,576,705</u>  |
| Distributions declared | <u>\$ 8,814,286</u>    | <u>\$ 21,139,285</u> |

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**24 Related party transactions**

Related party transactions have occurred in the normal course of operations and are measured at the exchange amount which is the amount established and agreed by the related parties. Shelter Canadian Properties Limited is a related party by virtue of the property management agreement and services agreement with the Trust and 2668921 Manitoba Ltd., the parent company to Shelter Canadian Properties Limited, is a related party as 2668921 Manitoba Ltd. is owned by a family member of an officer and Trustee of the Trust.

**Management agreement**

The Trust has extended the property management agreement with Shelter Canadian Properties Limited, with the same terms and conditions, to December 31, 2015. Under the property management agreement, Shelter Canadian Properties Limited will administer the day-to-day operations of the Trust's portfolio of income properties, except for the seniors housing complexes and Siena Apartments. The Trust pays property management fees equal to 4% of gross receipts from the income properties owned by the Trust. In regard to commercial properties, Shelter Canadian Properties Limited is also entitled to leasing commissions on new leases of 3% to 5% of base rental payments and leasing commissions on renewal of 1 1/2% to 2 1/2% of base rental payments. Shelter Canadian Properties Limited is also entitled to tenant improvement and renovation fees equal to 5% of the total cost of such work. Property management fees are included in property operating costs; leasing fees and tenant improvement fees are capitalized to income properties; and, during the period of major in-suite renovations or development, renovation fees are capitalized to the cost of buildings and properties under development.

The Trust incurred property management fees payable to Shelter Canadian Properties Limited of \$1,248,936 for the year ended December 31, 2010 (2009 - \$1,539,072). Property management fees are included in property operating costs.

The Trust incurred property management fees payable to Shelter Canadian Properties Limited on discontinued operations of \$1,040,109 for the year ended December 31, 2010 (2009 - \$1,089,163). Property management fees are included in property operating costs of discontinued operations.

The Trust incurred leasing commissions on commercial income properties included in discontinued operations payable to Shelter Canadian Properties Limited of \$60,555 for the year ended December 31, 2010 (2009 - \$113,453). The amounts are capitalized to the cost of properties held for sale.

Included in accounts payable and accrued liabilities at December 31, 2010 is a balance of \$22,033 (December 31, 2009 - \$16,066), payable to Shelter Canadian Properties Limited in regard to outstanding property management fees.

Included in accounts payable and accrued liabilities of discontinued operations at December 31, 2010 is a balance of \$2,707 (December 31, 2009 - \$12,144 recoverable), payable to Shelter Canadian Properties Limited in regard to outstanding property management fees.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**24 Related party transactions (continued)****Services agreement**

The Trust has extended the services agreement with Shelter Canadian Properties Limited for a term expiring on December 31, 2015. The terms of the services agreement were also amended in December 2010. Under the services agreement, Shelter Canadian Properties Limited provides the Trust management and support services for the administration of the day-to-day activities of the Trust. The Trust pays service fees equal to 0.3% of the gross book value of the assets of the Trust, excluding cash and defeasance assets.

The Trust incurred service fees of \$1,752,587 for the year ended December 31, 2010 (2009 - \$1,961,963). Service fees are included in trust expense.

**Financing**

On June 30, 2009, the Trust obtained a second mortgage loan in the amount of \$500,000 from 2668921 Manitoba Ltd. The loan bears interest at 7.5%, was due on January 1, 2011 and is secured by a second mortgage charge on an income property. The loan is included in mortgage loans payable at December 31, 2010. A processing fee of \$15,000 was paid to 2668921 Manitoba Ltd. in 2009 in regard to the loan and was included in transaction costs. Interest of \$37,500 for the year ended December 31, 2010 (2009 - \$24,657) is included in financing expense. Subsequent to December 31, 2010, the loan was extended to June 30, 2011 at the same terms and conditions, and a processing fee of \$7,500 was paid to 2668921 Manitoba Ltd. in regard to the extension of the loan.

On June 30, 2009, the Trust obtained a \$2.7 Million revolving loan commitment from 2668921 Manitoba Ltd. for general operating purposes. The loan commitment was increased to \$5 Million on September 2, 2009 and to \$10 Million on November 9, 2010. The loan bears interest at 14% (2009 - 7.5%), is due on June 30, 2011 and is secured by mortgage charges against the title to six income properties and the assignment of a \$500,000 mortgage loan receivable. As of December 31, 2010, \$7,350,000 has been drawn and is included in accounts payable.

Interest on the revolving loan of \$189,861 for the year ended December 31, 2010 (2009 - \$93,406) is included in financing expense.

The second mortgage loan and the revolving loan were approved by the independent Trustees.

**Guarantees**

Certain of the mortgage loans payable have been guaranteed by Shelter Canadian Properties Limited. There were not any fees charged to the Trust in regard to the guarantees.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**25 Financial instruments and risk management****Risk management**

In the normal course of business, the Trust is exposed to financial risk that arises from its indebtedness, including fluctuations in interest rates and in the credit quality of its tenants. Management's involvement in operations helps identify risks and variations from expectations. As a part of the overall operation of the Trust, management takes steps to avoid undue concentrations of risk. The Trust manages the risks, as follows:

**Liquidity risk**

The Trust is in breach of net operating income achievement and debt service coverage requirements and covenant restricting the registration of a secondary charge against the title to a property on mortgage loans totaling \$160,844,986 for five first mortgage loans and one second mortgage loan and \$25,041,369 for two first mortgage loans for two held for sale properties. The Trust is continuing to negotiate with the lenders and management believes that all of the covenant breaches will be resolved. As rental market conditions in Fort McMurray may not improve substantially in the near future, all of the affected properties may not attain income levels in 2011 which satisfy the existing debt service coverage requirements. There is no assurance that the lenders will not accelerate payment of the mortgage loans. There are no cross-default covenants with respect to the other mortgage loans of the Trust, other than the mortgage loans on income properties which are security for the mortgage bonds.

In addition to the liquidity risk noted above and relating to the mortgage financing for Parsons Landing (Note 28), liquidity risk arises from the possibility of the Trust not having sufficient debt and equity capital available to refinance its debt as it matures.

The risk associated with the refinancing of maturing debt is mitigated as the maturity dates of the mortgage portfolio are staggered over a number of years and by limiting the use of floating interest rate debt.

As at December 31, 2010, the weighted average term to maturity of the fixed rate mortgages on income properties is 3.3 years (2009 - 4.0 years).

The repayment obligations in regard to debt financial instruments are as follows:

| Year Ending<br>December 31 | Mortgage Loans<br>Payable | Convertible<br>Debentures<br>and Mortgage<br>Bonds | Defeased<br>Liability | Other Debt<br>Financial<br>Instruments | Total                 |
|----------------------------|---------------------------|----------------------------------------------------|-----------------------|----------------------------------------|-----------------------|
| 2011                       | \$ 166,615,440            | \$ 39,196,000                                      | \$ 50,897             | \$ 65,503,753                          | \$ 271,366,090        |
| 2012                       | 31,153,231                | -                                                  | 53,813                | -                                      | 31,207,044            |
| 2013                       | 39,031,649                | -                                                  | 56,896                | -                                      | 39,088,545            |
| 2014                       | 9,201,245                 | -                                                  | 60,155                | -                                      | 9,261,400             |
| 2015                       | 6,165,818                 | 12,637,000                                         | 63,602                | -                                      | 18,866,420            |
| Thereafter                 | 7,622,065                 | -                                                  | 2,520,859             | -                                      | 10,142,924            |
|                            | <u>\$ 259,789,448</u>     | <u>\$ 51,833,000</u>                               | <u>\$ 2,806,222</u>   | <u>\$ 65,503,753</u>                   | <u>\$ 379,932,423</u> |

In accordance with GAAP, the mortgage loans in the amount of \$160,844,986 that are not in compliance with net operating income achievement and debt service coverage requirements are included in principal repayments in 2011.



## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 200925 *Financial instruments and risk management (continued)***Interest rate risk**

Interest risk arises from debt financing including the risk that the Trust will not be able to refinance the mortgages with terms as favourable as those of existing mortgages. The risk is minimized by having the majority of the mortgage loans on fixed term arrangements. In addition, the maturity dates of the mortgages are staggered over a number of years to reduce the exposure in any one year. At December 31, 2010 the percentage of fixed rate mortgage loans (including mortgage loans with fixed rates under interest rate swaps) to total mortgage loans was 72% (2009 - 73%) and to the percentage of variable rate mortgage loans to total mortgage loans was 28% (2009 - 27%).

As at December 31, 2010, the Trust has mortgage loans totaling \$92,469,469 which mature on or prior to December 31, 2013, representing 36% of total mortgage loans. Should the amounts be refinanced upon maturity at an interest rate differential of 1%, financing expense would change by \$924,695 per year.

As at December 31, 2010, the Trust had variable rate mortgages totaling \$71,940,847. Should interest rates change by 1%, financing expense would change by \$719,408 per year.

With the exception of interest rate swap arrangements, the Trust does not trade in financial instruments.

**Credit risk**

Credit risk arises from the possibility that tenants may be unable to fulfil their lease commitments. The maximum exposure to credit risk is equal to the carrying value of the financial assets. The Trust has credit policies to address credit risk which include the analysis of the financial position and credit history of a prospective tenant and by obtaining security deposits whenever permitted by legislation. An allowance for doubtful accounts or other impairment provisions are established based upon factors surrounding credit risk, historical trends and other information.

Rent is past due when a tenant has failed to make a payment when contractually due. The following is an aging of rent receivable past due but not impaired:

|                                 | December 31       |                   |
|---------------------------------|-------------------|-------------------|
|                                 | 2010              | 2009              |
| <u>Rent receivable overdue:</u> |                   |                   |
| 0 to 30 days                    | \$ 141,705        | \$ 127,814        |
| 31 to 60 days                   | 29,741            | 31,883            |
| More than 60 days               | 204,023           | 242,045           |
|                                 | <u>\$ 375,469</u> | <u>\$ 401,742</u> |

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**25 Financial instruments and risk management (continued)****Credit risk (continued)**

A reconciliation of allowance for doubtful accounts is as follows:

|                                                                              | December 31      |                  |
|------------------------------------------------------------------------------|------------------|------------------|
|                                                                              | 2010             | 2009             |
| Balance, beginning of year                                                   | \$ 90,680        | \$ 64,818        |
| Amount charged to bad debt expense relating to impairment of rent receivable | 42,526           | 180,821          |
| Amounts written off as uncollectible                                         | (98,800)         | (154,959)        |
| Balance, end of year                                                         | <u>\$ 34,406</u> | <u>\$ 90,680</u> |
| Amount charged to bad debts as a percent of rentals from income properties   | 0.14%            | 0.46%            |

**Currency risk**

Currency risk is the risk that changes in foreign exchange rates may have an effect on future cash flows associated with financial instruments. The Trust does not have any transactions denominated in foreign currency and is not exposed to foreign currency risk.

**Other price risk**

Other price risk is the risk that changes in market prices, including commodity or equity prices, will have an effect on future cash flows associated with financial instruments. The cash flows associated with financial instruments of the Trust are not exposed to other price risk.

**Fair values**

Financial instruments include mortgage loans receivable, cash, restricted cash, amounts receivable, defeasance assets, mortgage loans payable, mortgage bonds, the debt component of convertible debentures, accounts payable and accrued liabilities, interest rate swaps, bank indebtedness and the defeased liability.

Fair value is an estimate of the amount at which items might be exchanged in an arm's length transaction between knowledgeable willing parties who are under no compulsion to act. Fair value should not be interpreted as an amount that could be realized in immediate settlement of the instruments. The estimate of fair value at the financial statement date may not represent fair values at any other date. The determination of fair value is affected by the use of judgment and by uncertainty.

Financial instruments carried at fair value include cash, restricted cash, interest rate swaps and bank indebtedness. The methods used to establish fair values are summarized as follows:

- Quoted prices in active markets for identical assets or liabilities;
- Use of a model with inputs other than quoted prices that are directly or indirectly observable market data.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 200925 *Financial instruments and risk management (continued)***Fair values (continued)**

The following schedule summarizes the method used to determine the fair value of financial instruments, which are carried at fair value.

|                     | December 31, 2010    |                        | December 31, 2009    |                        |
|---------------------|----------------------|------------------------|----------------------|------------------------|
|                     | <u>Quoted Prices</u> | <u>Observed Inputs</u> | <u>Quoted Prices</u> | <u>Observed Inputs</u> |
| Cash                | \$ 1,697,498         | \$ -                   | \$ 4,287,864         | \$ -                   |
| Restricted cash     | 20,343,338           | -                      | 5,028,520            | -                      |
| Interest rate swaps | -                    | 3,594,573              | -                    | 6,306,198              |
| Bank indebtedness   | 2,960,000            | -                      | -                    | -                      |

The carrying values of amounts receivable and accounts payable and accrued liabilities approximate fair value due to the short term nature of the financial instruments.

The fair value of the mortgage loans receivable is impacted by the difference between the yield for such instruments in an open market and the yield negotiated as part of a sale of property and by changes in market yields. The fair value of the mortgage loans receivable has been estimated based on the current market rates for second mortgage loans with similar terms and conditions. The estimated fair value of mortgage loans receivable at December 31, 2010 is \$400,000 (December 31, 2009 - \$7,390,000).

The fair value of the fixed rate mortgage loans payable are impacted by changes in market yields which can result in differences between the carrying value and fair value of the instruments. The fair value of mortgage loans payable has been estimated based on the current market rates for mortgage loans with similar terms and conditions. The estimated fair value of mortgage loans payable at December 31, 2010 is \$260,400,000 (December 31, 2009 - \$280,800,000).

The fair value of the mortgage bonds is impacted by changes in market yields which can result in differences between the carrying value and the fair value of the instrument. The fair value of the mortgage bonds has been estimated based on the current market rate for mortgage loans with similar terms and conditions. The estimated fair value of the mortgage bonds payable at December 31, 2010 is \$11,300,000 (December 31, 2009 - nil).

The carrying value of the debt component of convertible debentures payable are impacted by changes in market yields which can result in differences between the carrying value and fair value of instruments. The fair value of the debt component of convertible debentures payable has been estimated based on the current market rates for debentures with similar terms and conditions. The estimated fair value of the debt component of convertible debentures payable at December 31, 2010 is \$31,800,000 (December 31, 2009 - \$31,300,000).

The fair value of the defeasance assets is impacted by changes in market yields which can result in differences between the carrying value and the fair value of the instruments. The fair value of the defeasance assets is based on market price for the bonds which comprise the defeasance assets. The fair value of the defeasance assets at December 31, 2010 is \$3,237,487 (December 31, 2009 - nil).

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**25 Financial instruments and risk management (continued)****Fair values (continued)**

The fair value of the defeased liability is impacted by changes in market yields which can result in differences between the carrying value and the fair value of the instruments. The fair value of the defeased liability has been estimated based on current market rates for mortgages with similar terms and conditions. The estimated fair value of the defeased loan at December 31, 2010 is \$2,810,000 (December 31, 2009 - nil).

**26 Management of capital**

The capital structure of the Trust is comprised of the following:

|                                         | December 31          |                      |
|-----------------------------------------|----------------------|----------------------|
|                                         | 2010                 | 2009                 |
| Mortgage loans payable                  | \$258,713,190        | \$271,414,070        |
| Mortgage bonds                          | 9,317,075            | -                    |
| Convertible debentures - debt component | 36,986,646           | 45,940,843           |
| Equity                                  | 39,739,235           | 41,539,887           |
|                                         | <u>\$344,756,146</u> | <u>\$358,894,800</u> |

The Trust manages capital in order to safeguard its ability to continue as a going concern and to ensure an appropriate balance of risk and return.

The overall capital management strategy addresses the following considerations:

- The equity component of acquired properties is primarily funded from the proceeds of trust units or convertible debentures.
- Mortgage debt financing is arranged to optimize the leveraged returns from the real estate portfolio.
- Total mortgage debt financing is maintained within the overall debt limits as established by the Declaration of Trust. The Declaration of Trust provides for mortgage indebtedness of the Trust up to 75% of the appraised value of all properties.
- Whenever appropriate, the Trust will utilize fixed rate debt financing.
- Mortgage due dates are structured to reflect the properties being financed and debt maturity dates will be staggered, to the extent practicable, in order to reduce refinancing risk.
- The Trust is undertaking a divestiture program targeting the sale of assets in order to reduce total debt including convertible debenture debt and higher cost mortgage loan financing.

The Trust monitors capital from time-to-time using a variety of measures. Monitoring procedures are performed as a part of the overall management of operations and are performed with the goal of enhancing the ability of the Trust to access capital and/or reduce the cost of capital.

In order to maintain or adjust the capital structure the Trust may (i) issue units, debentures or mortgage debt and other securities, such as unit purchase warrants; (ii) adjust the amount of distributions (if any) paid to unitholders; (iii) return capital to unitholders; (iv) purchase units or debentures; or (v) reduce debt.



## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**26 Management of capital (continued)**

Market requirements for attracting capital may vary in ways that the Trust may not be able to accurately predict.

**27 Segmented financial information**

The assets are located in Fort McMurray, Alberta (13 properties), Yellowknife, Northwest Territories (2 properties) and other locations in Canada (4 properties).

Revenue is primarily derived from the operations of residential real estate comprised of multi family rental properties.

Year ended December 31, 2010:

|                                          | Fort<br>McMurray | Yellowknife | Other      | Trust        | Total        |
|------------------------------------------|------------------|-------------|------------|--------------|--------------|
| Rentals from income properties           | 23,956,986       | 5,407,251   | 2,021,677  | -            | 31,385,914   |
| Interest and other income                | 194,869          | 18,039      | 20,363     | 725,878      | 959,149      |
| Property operating costs                 | 9,411,743        | 2,188,444   | 864,060    | -            | 12,464,247   |
| Financing expense                        | 14,972,007       | 892,836     | 723,630    | 12,204,640   | 28,793,113   |
| Amortization                             | 7,353,094        | 696,939     | 463,114    | -            | 8,513,147    |
| Income (loss) from continuing operations | (7,584,990)      | 1,647,071   | (8,763)    | (14,514,345) | (20,461,027) |
| Total assets from continuing operations  | 327,998,797      | 26,740,034  | 12,675,870 | 21,730,172   | 389,144,873  |

Year ended December 31, 2009:

|                                                              | Fort<br>McMurray | Yellowknife | Other      | Trust        | Total        |
|--------------------------------------------------------------|------------------|-------------|------------|--------------|--------------|
| Rentals from income properties                               | 32,433,428       | 5,171,141   | 2,058,380  | -            | 39,662,949   |
| Interest and other income                                    | 320,266          | 20,697      | 23,896     | 26,863       | 391,722      |
| Property operating costs                                     | 9,817,401        | 2,118,468   | 791,476    | -            | 12,727,345   |
| Financing expense                                            | 18,976,939       | 913,000     | 662,564    | 8,515,936    | 29,068,439   |
| Amortization                                                 | 7,323,073        | 689,220     | 453,687    | -            | 8,465,980    |
| Income (loss) from continuing operations                     | (3,363,719)      | 1,471,147   | 174,555    | (13,948,416) | (15,666,433) |
| Total assets from continuing operations at December 31, 2009 | 334,990,309      | 28,524,006  | 11,815,253 | 12,771,163   | 388,100,731  |

**28 Commitments****Acquisition****Parsons Landing Apartments**

On September 1, 2008, the Trust acquired possession of Parsons Landing, a residential property located in Fort McMurray, Alberta, for a total cost of \$63,200,000, including GST. On November 1, 2007, the Trust provided a \$10,000,000 second mortgage loan which bore interest at 8%. On possession of Phase I of the property on May 14, 2008, a purchase instalment payment of \$2,500,000 was made and \$5,250,000 of the second mortgage loan was applied to the purchase price. On possession of Phase II of the property on September 1, 2008, the balance of the second mortgage loan of \$4,750,000 was applied to the purchase price. After accounting for the payment of an additional deposit of \$2,500,000 on October 1, 2008, the balance owing on Parsons Landing was \$48,220,000 as of December 31, 2008, including GST. The balance owing was originally due on February 28, 2009.

## LANESBOROUGH REAL ESTATE INVESTMENT TRUST

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009**28**      *Commitments (continued)***Acquisition (continued)****Parsons Landing Apartments (continued)**

The permanent mortgage financing for Parsons Landing is uncompleted and, as a result, the vendor has agreed to several extensions of the deadline for payment of the balance owing, the latest of which extends the deadline for payment of the balance owing to June 30, 2011, with interest of \$15,722,287 from January 1, 2010 to June 30, 2011. The vendor has agreed to accept interest payments of \$300,000 per month to June 30, 2011 and to forgive interest in excess of \$300,000 per month, for the period from January 1, 2010 to June 30, 2011 in the amount of \$10,322,287, on closing. A purchase instalment payment of \$500,000 was also made on May 12, 2009.

On closing, the vendor has agreed to provide a second mortgage to a maximum of \$12,000,000, for a 15 month term with interest at 8% for the first 8 months, 12% for the next 4 months and 24% thereafter, provided that the Trust makes an additional payment in a minimum amount of \$5,000,000, prior to closing. On closing, the vendor has also agreed to provide a credit of \$1,440,000 for furniture purchased by the Trust.

The payment extension is conditional upon the Trust obtaining a commitment for mortgage financing by April 30, 2011.

As of December 31, 2010, the amount payable in regard to the acquisition of Parsons Landing, including GST and excluding accrued interest, is \$47,720,000.

The Trust may also elect at any time to surrender possession of Parsons Landing, along with the furniture, to the vendor for the amount of \$1.

**Management Contracts**

The Trust has retained the following third party managers to provide on-site management services to the seniors housing complexes:

| <u>Property</u>              | <u>Manager</u>                | <u>Term Expiring</u> |
|------------------------------|-------------------------------|----------------------|
| Riverside Terrace            | LutherCare Communities        | July 31, 2015        |
| Chateau St. Michael's        | Integrated Life Care Inc.     | September 30, 2015   |
| Elgin Lodge                  | Kingsway Arms Management Inc. | May 31, 2016         |
| Clarington Seniors Residence | Kingsway Arms Management Inc. | February 12, 2017    |

In addition, Siena Apartments is managed by Pacer Management Inc. for a term expiring 2012.

**LANESBOROUGH REAL ESTATE INVESTMENT TRUST****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009****29      *Contingencies*****GST Assessment**

The Trust has been assessed for additional GST in the amount of \$2,393,503, plus interest of \$335,659, for a total amount of \$2,729,162 in regard to the acquisition of a property in Fort McMurray. The Trust has appealed the assessment. The outcome of the appeal is uncertain and, as a result, the Trust has not made an accrual in this regard.

**Contingent consideration - Elgin Lodge**

During the five year period from June 1, 2006, Kingsway Arms Management Services Inc. is entitled to a one-time payment equal to 50% of the amount by which the appraised value of the expanded Elgin Lodge property exceeds the total of the cost to the Trust, including the expansion costs and the unpaid portion of a 12% return on equity. Contingent consideration recorded at December 31, 2010 of \$434,982 (2009 - \$434,982) is included in assets of discontinued operations.

**Contingent consideration - Clarington Seniors Residence**

During the five year period after lease-up is achieved, Kingsway Arms Management Services Inc. is entitled to a one-time payment equal to 50% of the amount by which the appraised value of the property exceeds the total of the acquisition cost to the Trust and the unpaid portion of an 8% return on equity. Contingent consideration recorded at December 31, 2010 of \$477,901 (2009 - \$477,901) is included in assets of discontinued operations.

**30      *Subsequent events*****Convertible Debentures**

On March 11, 2011, the Series F debentures matured and were repaid in full.

**Public Offering Mortgage Bonds and Warrants**

On January 28, 2011, the Trust issued 3,363 five year 9% mortgage bonds in the principal amount of \$1,000 per unit, due December 24, 2015, and 3,363,000 warrants for gross proceeds of \$3,363,000. The aggregate gross proceeds of the mortgage bond and warrant offering which closed on December 23, 2010 and January 28, 2011 were \$16,000,000. Each warrant entitles the holder to purchase one unit at a price of \$0.75 until December 23, 2015.

The proceeds were held in escrow to partially fund the repayment of the Series F debentures.

**Bank indebtedness**

Subsequent to December 31, 2010, the Trust utilized \$1,915,000 of the line of credit.

**Revolving loan**

Subsequent to December 31, 2010, the Trust utilized \$3,650,000 of and repaid \$1,000,000 on the revolving loan from 2668921 Manitoba Ltd.

**LANESBOROUGH REAL ESTATE INVESTMENT TRUST****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2010 AND 2009****30 Subsequent events (continued)****Mortgage refinancing**

Subsequent to December 31, 2010, a new second mortgage loan was obtained in the amount of \$400,000 bearing interest at 9% and maturing September 1, 2013.

A new mortgage loan in the amount of \$16,300,000 bearing interest of 8% and maturing on April 2013 has been arranged with funding by March 31, 2011. The proceeds of the loan will be used to retire a 12 1/2% interim mortgage loan in the amount of \$11,500,000 and partially repay the revolving loan.

**31 Comparative figures**

As a result of the reclassification of certain properties from income properties to assets of properties held for sale; certain of the prior year figures have been reclassified.



## UNITHOLDER INFORMATION

### Trustees and Officers

The investment policies and operations of LREIT are subject to the control of the trustees, pursuant to the terms of a Declaration of Trust. The Declaration of Trust provides for a minimum of three trustees and a maximum of ten trustees and requires that the majority of trustees be independent trustees. The Declaration of Trust provides Shelter Canadian Properties Limited with the right to appoint one trustee.

The current trustees of LREIT are Mr. Charles Loewen, Mr. Earl Coleman, Ms. Cheryl Barker, CA and Mr. Arni Thorsteinson, CFA. Mr. Loewen is the Chief Executive Officer of Online Business Systems and serves as Chairman of LREIT. Mr. Coleman is the President of Big Freight Systems Inc. Ms. Barker was the President, MTS (Manitoba) prior to her retirement in 2006. Mr. Thorsteinson is the President of Shelter Canadian Properties Limited and serves as Chief Executive Officer of LREIT. Mr. Thorsteinson is the appointee of Shelter Canadian Properties Limited.

The Chief Financial Officer and Secretary of LREIT is Mr. Kenneth Dando, CA, Senior Manager of Corporate Reporting and Administration for Shelter Canadian Properties Limited.

### Administrator of the Trust

Shelter Canadian Properties Limited has been appointed by the Trustees, pursuant to the terms of a Services Agreement, to administer the daily affairs of LREIT and to perform the accounting and reporting functions of LREIT.

### Property Management

Shelter Canadian Properties Limited has been appointed by the Trustees, pursuant to the terms of the Property Management Agreement, to act as the Property Manager for all of the income properties in the LREIT portfolio. Shelter Canadian Properties Limited manages all of the income properties except for the Siena Apartments and the seniors' housing complexes, where the Trust has retained third party property managers to provide on-site management services, due to the nature of the operations.

### Office Address

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Email: [info@lreit.com](mailto:info@lreit.com)  
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### Transfer Agent and Registrar

Canada Stock Transfer Company Inc.  
600, 333 - 7th Avenue S.W.  
Calgary, Alberta T2P 2Z1

### Auditors

Meyers Norris Penny, LLP  
Chartered Accountants  
2500 - 201 Portage Avenue  
Winnipeg, Manitoba R3B 3K6

### Unit Listing

Toronto Stock Exchange (TSX)

|                                |          |
|--------------------------------|----------|
| Unit trading symbol:           | LRT.UN   |
| Debenture trading symbol:      | LRT.DB.G |
| Mortgage bonds trading symbol: | LRT.NT.A |
| Warrants trading symbols:      | LRT.WT   |
|                                | LRT.WT.A |

### Legal Counsel

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### Unitholder and Investor Contact

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